MonetaGroup®

INVESTMENT

Insights

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We believe that controlling volatility and downside risk—within the construct of each investor's unique risk/reward tolerance—is an important step in meeting long-term financial goals.

We are true believers in the concept of diversification, both within and among the various asset classes and strategies that are available to our clients.

A MONTHLY INVESTMENT COMMENTARY FROM YOUR TRUSTED INVESTMENT ADVISORS AT MONETA GROUP

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The "Conundrum" of U.S. Bond Yields

In February 2005, then U.S. Federal Reserve Chairman Alan Greenspan noted the "conundrum" of 10-year Treasury yields failing to rise despite a 150-basis-point increase in the federal funds rate. Since then, U.S. bond yields have gradually declined, in part due to extraordinary monetary policy in the wake of the credit crisis, a disinflationary environment and low (and in some cases, negative) global bond yields.

At approximately 1.75%, the current 10-year U.S. Treasury benchmark note yield actually looks high in comparison to other developed countries, such as Germany (0.13%), Japan (-0.09%) and the United Kingdom (1.42%). Paradoxically, the yield on the 10-year Treasury has actually declined since the Fed increased rates in mid-December.

Instead of trying to forecast the direction that bond yields may be headed, we thought we'd discuss the inherent risks of low bond yields. Most of us are aware of the "seesaw" nature of bond prices and yields (yields up, prices down and vice versa) but maybe not the fact that this dynamic is accentuated at lower rates. The market risk for a 10-year bond that yields 2% is higher than a comparable bond at 5%-6%.

Duration of the Bond Market Has Extended

One way that market risk can be gauged is through a calculation

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Bond Yields, continued...

called "duration," which measures how likely a bond's price is to move when interest rates change, expressed in years. The higher the duration, the more a bond's price will fall when interest rates rise.

For example, let's look at an investment in two different 10-year bonds: one bond has a 6% coupon and one bond is a zero-coupon, both priced to yield 6% to maturity. The investor with the 6% coupon receives 21 payments: 20 semiannual interest payments and the return of principal at maturity, while the zero-coupon holder gets one payment at maturity. Which has the lower duration? The first bond, at 7.3 years (versus 10 years for the zero-coupon bond), because the investor is receiving capital back sooner through coupon payments. Credit quality, maturity and yields are all the same, but the longer duration increases the interest-rate sensitivity (risk) of one versus the other by approximately 20% in a rising-rate environment.

The widely followed Barclays Aggregate Index (the S&P 500 of the bond market) has seen its duration increase from 4 years in January 2008 to 5.43 years today, and the same can be said of many investors' portfolios. While one's average maturity may not have changed, it is highly likely the duration has increased, also increasing the sensitivity to yield changes.

Real (Inflation-Adjusted Yields) Are Historically Low

Fixed income has long been a source of stable returns for multi-asset portfolios, even in periods of equity weakness. Yields have generally declined over the past 35 years, providing a tremendous tailwind for fixed-income returns. However, today's low interest rates are an anchor in terms of returns for those same multi-asset portfolios.

The accompanying chart shows the very high correlation between the starting yield of a bond and the subsequent 10-year return. In other words, an investment in a 10-year bond at 7% and held until maturity should produce an annualized 7% return. The same is true if the starting yield is closer to 2%.

Put another way, it will be very difficult for fixed income (as represented by the Barclays Aggregate) to replicate the since-inception 7.71% annualized return from today's starting index yield of 2.13% (which is roughly equivalent to core inflation as measured by the consumer price index, ex-food and energy). Historically, bonds have yielded an average of 3% above core inflation. That spread is now negligible at best to negative at worst.

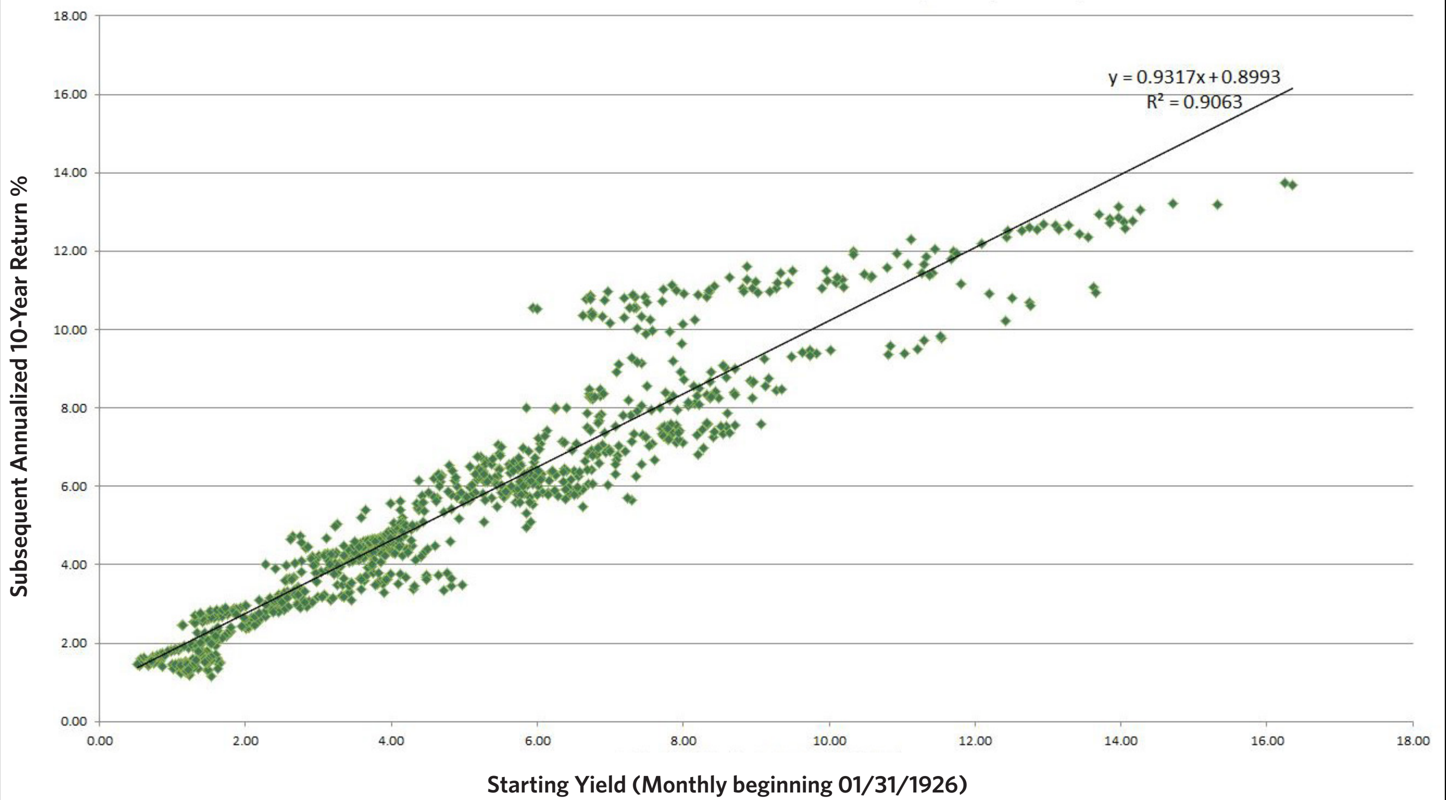
> **"Forecasting financial markets accurately for any extended period is an impossible task, and the bond market has seemingly defied all logic for more than a decade."**

All of this begs the question of whether or not fixed income has a role in multi-asset portfolios. The answer is of course, but with the caveat that no investment strategy is risk-free. Market risk or interest-rate sensitivity can be mitigated through a variety of strategies, two of the simplest being adjusting maturities or by investing in premium bonds. Investors can opt for an increased amount of higher-return, higher-risk investments (equities, real estate, junk bonds) to generate higher returns (with more volatility) or acknowledge the risk of loss of purchasing power by investing in bonds that yield little after inflation. Regardless, fixed income still provides equity-market risk-mitigation properties, liquidity and some income, albeit at the cost of low returns. Most portfolios benefit from these characteristics.

Other Considerations

So far we have been talking about the risks to individual investors of low yields. Casting a broader net reveals others. One example would be the impact on insurance companies that have traditionally used long-duration fixed-income assets to anchor investment portfolios. The low returns are a risk to their margins and business. And the post-Great Recession increase in federal debt has been masked by sustained low interest rates of the past seven years.

Forecasting financial markets accurately for any extended period is an impossible task, and the bond market has seemingly defied all logic for more than a decade. With foreign central banks experimenting with negative monetary policy and foreign yields low—and in some cases, negative—it's hard to imagine U.S. yields moving significantly higher in the short and intermediate term. We continue to believe there is a portfolio role for fixed-income assets although we also remain aware of the heightened risks currently embedded in this asset class.



Source: Moneta Group Calculation

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