"The Holy Grail of portfolio construction is negatively correlated assets."

—CIO Ken Leech

5 Reasons Why Fixed-Income Still Matters

Diversification as an investing principle never goes out of style. But in today's low-rate environment, do bonds still provide effective diversification in a traditional asset allocation framework? Are the reasons for owning fixed-income the same as they have been in the past?

The short answer to both questions is a resounding "Yes."

In today's low-yield world, fixed-income plays as vital a role as ever.

Key Takeaways

- *Fixed-income is the only asset class that demonstrates a low to negative correlation to risk assets.*
- *Fixed-income provides highly efficient returns per unit of risk.*
- *Fixed-income is an effective tool to manage drawdown risk.*
- *A passive manager cannot express duration, curve, sector or security preferences in portfolio construction in the ways that an active manager can.*

Many investors need to maintain rate-of-return targets to meet ongoing spending needs and satisfy other liabilities, but may face significant hurdles in achieving these targets given current market valuations and the low level of global bond yields. And choosing the right mix of assets to maintain prudent diversification while still striving to meet these rate-of-return targets can certainly present challenges.

Addressing these needs and challenges requires a nuanced understanding of the context in which investors make decisions—and the context is always changing. Today, we're in a very uncertain environment—not only are we grappling globally with the COVID-19 pandemic, we're also facing geopolitical tensions (e.g., US-China trade, Brexit, the Middle East), as well as deflation/disinflation pressure (due to slow growth combined with too much debt). Central banks worldwide, including the Federal Reserve (Fed), have instituted monetary easing programs to keep interest rates low as a means to stimulate economic growth, largely due to the pandemic. The following quote encapsulates the current monetary stance:

> *"We're not even thinking about thinking about raising rates. We're totally focused on providing the economy the support that it will need. We think that the economy will need highly accommodative monetary policy and the use of our tools for an extended period. And we're absolutely committed to staying in this until—until we're very confident that that is no longer needed."*
>
> *~Jerome Powell, Fed Chair*

If this uncertain landscape persists for the foreseeable future, we would expect global financial markets to be volatile and for risk-free yields to remain low given the continued policy support. However, we can also see a scenario wherein successful implementation of effective vaccines suddenly resets global growth and inflation expectations; this would result in an equally volatile market, with US rates moving higher (yield curve steepening) in the short term and credit spreads widening as valuations adjust to a new rate environment.

Here are five reasons why we believe fixed-income should continue to be an important part of investors' portfolios.

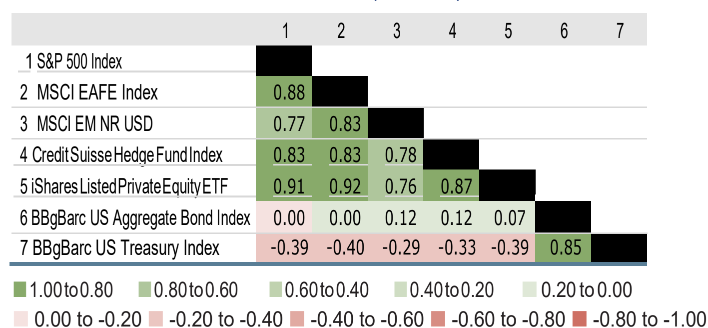
Active management in fixed-income has never been more relevant. Here are five reasons why.

1 **Diversification:** Fixed-income offers a low to negative correlation to risk assets.

The correlation of risk assets to one another (Exhibit 1) highlights the importance of selecting diversifying assets. Over the past several years, it's been very popular for institutional investors to allocate significant percentages to hedge funds and private equity; however, we would note that the correlation to public equities ranges from 0.76 to 0.92. The trailing five-year correlation of the S&P 500 with non-US equities ranges from 0.77 to 0.88 and is highly correlated by any definition. The only asset that demonstrates a low to negative correlation to risk assets is fixed-income. Here, the range of correlations for traditional fixed-income ranges from -0.40 to 0.00. This range suggests that fixed-income is either not correlated (0.00) or negatively correlated (-0.40) relative to traditional risk assets. This underscores the importance of using fixed-income as a diversification tool.

As always, there's little visibility regarding what may actually happen over the next six to 12 months. This means it's difficult to know which asset class will outperform and which one can act as the best portfolio hedge. As a result, portfolio diversification still matters—it always has and always will. The rate of return is an important consideration, but so is risk management given perennial uncertainty. Effective risk management starts with appropriate diversification. And there's no better diversifying asset class than fixed-income.

Exhibit 1: Return Correlation Matrix (5 Years)



	1	2	3	4	5	6	7
1 S&P 500 Index							
2 MSCI EAFE Index	0.88						
3 MSCI EM NR USD	0.77	0.83					
4 Credit Suisse Hedge Fund Index	0.83	0.83	0.78				
5 iShares Listed Private Equity ETF	0.91	0.92	0.76	0.87			
6 BBgBarc US Aggregate Bond Index	0.00	0.00	0.12	0.12	0.07		
7 BBgBarc US Treasury Index	-0.39	-0.40	-0.29	-0.33	-0.39	0.85	

1.00 to 0.80 | 0.80 to 0.60 | 0.60 to 0.40 | 0.40 to 0.20 | 0.20 to 0.00 | 0.00 to -0.20 | -0.20 to -0.40 | -0.40 to -0.60 | -0.60 to -0.80 | -0.80 to -1.00

Source: Morningstar Direct. As of 31 Dec 20.

2 **Efficiency:** Fixed-income's modest risk profile allows for efficient returns per unit of risk.

While we acknowledge that potential returns for fixed-income may appear to be limited in the current market environment, investors should consider whether designating some capital to fixed-income is an efficient allocation considering the modest risk profile of the asset class (i.e., standard deviation of annual returns). Exhibit 2 illustrates the return/risk ratio for various asset classes for the trailing five years (all returns annualized). The return/risk ratio for the Bloomberg Barclays (BB) US Aggregate Bond Index is 1.40—this is the most efficient allocation across the major asset classes shown in Exhibit2.

Exhibit 2: Return Per Unit of Risk

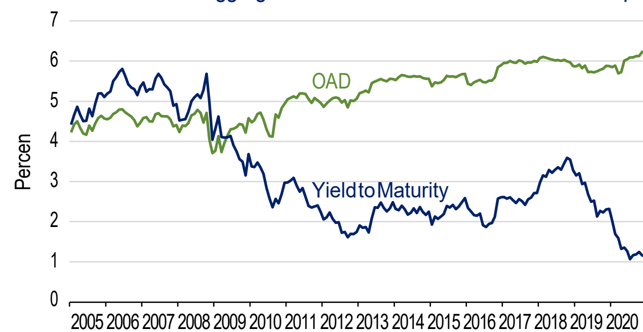
Asset Class	Return	Std Dev	Return/Risk
S&P 500 Index	15.2	15.3	1.00
MSCI EAFE Index	7.4	15.4	0.48
MSCI EM NR USD	12.8	17.6	0.73
Credit Suisse Hedge Fund Index	4.1	5.5	0.74
iShares Listed Private Equity ETF	13.2	22.3	0.59
BBgBarc US Aggregate Bond Index	4.4	3.2	1.40
BBgBarc US Treasury Index	3.8	4.0	0.95

Source: Morningstar Direct. As of 31 Dec 20.

3 Underlying Return Potential: While fixed-income yields may be the top-line indicator of returns, they may not tell the full story.

It's important to bear in mind that uncertain markets can translate into volatility that, in turn, can produce returns well above what a security may be yielding at the time. For instance, Exhibit 3 shows the historical relationship between the yield-to-maturity for the BB US Aggregate Bond Index and the option-adjusted duration (OAD). It's true the investable characteristics of the Aggregate Index in early 2020 probably looked somewhat unattractive to investors, but Exhibit 4 illustrates how the BB Aggregate Index returned 7.51% for the calendar year 2020. The return on the BB Aggregate clearly outpaced private equity and hedge funds. So, in a year (2020) when many investors questioned the return prospects for the BB Aggregate, it returned 7.51%.

Exhibit 3: BB US Bond Aggregate Index—the OAD and YTM Relationship



Source: Bloomberg Barclays. As of 31 Dec 20.

Exhibit 4: 2020 Index Returns

	2020 Return (%)
S&P 500 Index	18.40
MSCI EAFE Index	7.82
MSCI EM NR USD	18.31
Credit Suisse Hedge Fund Index	6.36
iShares Listed Private Equity ETF	5.36
BBgBarc US Aggregate Bond Index	7.51
BBgBarc US Treasury Index	8.00

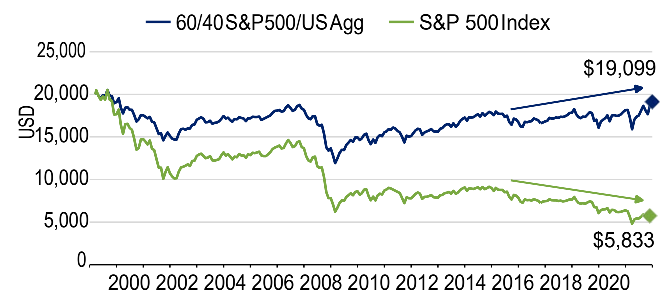
Source: Morningstar Direct. As of 31 Dec 20.

4 Drawdown Risk Mitigation: Fixed-income can serve as an effective tool for investors in the decumulation phase.

There are few asset classes that can mitigate drawdown risk while providing income/return potential and liquidity. For example, commodities such as gold offer no income source. Alternative asset classes such as real estate or private credit may offer long-term return potential, but these asset classes come with difficulties related to estimating valuations and are highly illiquid. Also, while there has been a clear bias toward private credit in recent years as investors hunt for yield, have investors really seen how those investments will perform during a prolonged bear-market scenario? With public fixed-income, investors can use US Treasuries as ballast in portfolios or TIPS to hedge against rising rates—both of these markets are deep and liquid. For investors with a greater risk tolerance, they can hold an allocation to floating-rate corporates or bank loans, both of which offer income as well as some degree of protection in a rising-rate scenario.

Exhibit 5: Avoiding a Drawdown Death Spiral

60/40 Portfolio vs. S&P 500 Index—4% Initial Withdrawal, 3% Annual Increase



Source: Bloomberg. As of 31 Dec 20

As a stark reminder, the Dow Jones Industrial Index high point early in 2020 was at 29,511 on February 12 but closed at 18,591 on March 23—a 37% drop in about 40 days. Conversely, the 30-year Treasury yield hit its 2020 peak of 2.38% on January 9, 2020. This may have seemed unattractive to the novice investor, but in terms of diversification and return potential, holding the 30-year Treasury bond was a winning proposition. It hit an all-time low of 0.99% on March 9, 2020, which netted more experienced investors a handsome 32% return.

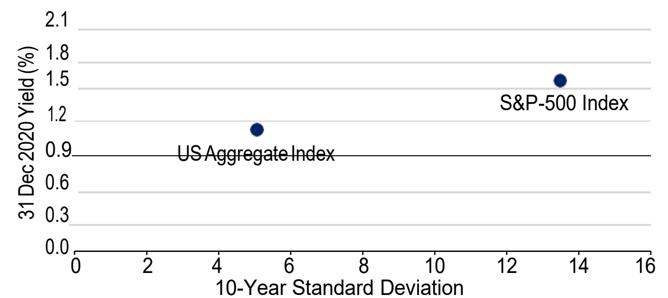
5 Income Generation: Fixed-income still has the potential to deliver attractive relative returns.

Over the last 10 years, the BB US Aggregate Bond Index has generated a cumulative total return of 45.76%. A little-known fact behind this number is that the cumulative contribution from the income component is 36.73% (or 80% of the total return).

Any investor (retail or institutional) needs repeatable income to meet ongoing expenses, pension payments, etc. As part of their asset allocation exercises, investors often compare the yield on the 10-year Treasury (currently at 1.07%*) to the dividend yield of the S&P 500. While it's true that the current dividend yield of the S&P 500 is 1.60%*—roughly 50% more than the yield on the 10-year Treasury—capturing that dividend yield means investing in an equity index that has exhibited an annualized volatility of 13.5% for the last 10 years (as compared to the BB US Aggregate Index that has posted annualized volatility of 2.9%*). Currently, the BB US Aggregate Index produces an annualized coupon of 2.76%* (again, not compounded). The actual yield-to-maturity of the Bloomberg Barclays Aggregate Index is currently 1.14%.* But, it's important to remember that markets can reset yields and spreads materially higher in a short period of time (e.g., witness the spread widening during March 2020). It's fair to say that the BB US Aggregate Index (or any specific fixed-income sector) should continue to produce much-needed income regardless of the market environment, yield and spread levels. What's more, despite the low levels of yields on a historical basis, fixed-income still delivers attractive returns and low volatility—and its income remains a big driver of overall total return. These are all critical variables for investors at or near retirement age and for large institutions meeting their obligations.

*As of 31 Dec 20.

Exhibit 6: Risk vs. Yield

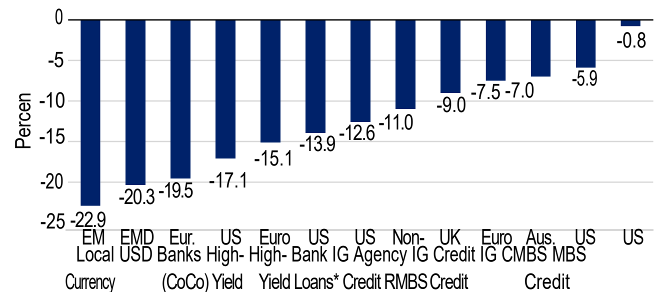


Source: Bloomberg. As of 31 Dec 20

Active Management Is Critical in Fixed-Income

While these five reasons we provide should remind all investors that fixed-income plays an important role in asset allocation and portfolio construction, we cannot stress enough that pursuing a passive approach introduces dangers and limitations. Passively managed index-linked products have considerable exposure to duration risk. For example, the Global Aggregate Index has over seven years of duration, while the BB US Aggregate and investment-grade credit indices have also seen a marked extension in duration. Moreover, the largest constituents in these indices are the largest borrowers. Doesn't it seem a bit counterintuitive, then, that an investor would hire a passive fixed-income manager that must buy and hold those issuers that are the most indebted? A passive manager cannot express duration, curve, sector or security preferences in the portfolio construction in the ways that an active manager can.

Exhibit 7: 1Q20 Excess Returns



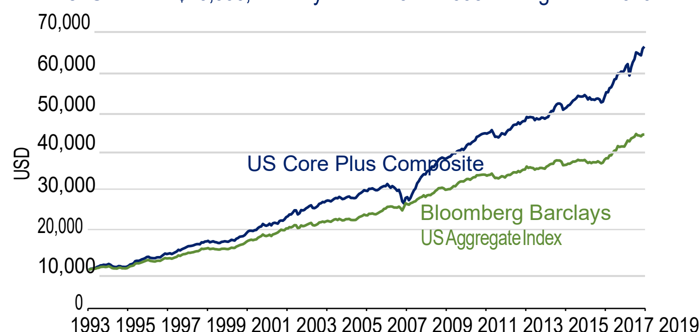
Source: Bloomberg Barclays, J.P. Morgan, S&P Global Market Intelligence, a division of S&P Global Inc, Western Asset. As of 31 Dec 20
**S&P/LSTA Performing Loans Index excess return vs. 3-Month LIBOR*

For instance, Exhibit 7 illustrates the extent of spread widening caused by the COVID-19 pandemic in March 2020. As a fundamental and value-oriented investor, Western Asset saw a number of highly

compelling investment opportunities across many sectors in early 2Q20. During this period, the Firm added to investment-grade credit given significant spread concession in the primary market and attractive spread levels in the secondary market. These positions benefited greatly following the Fed's announcement that it would roll out the Primary and Secondary Market Corporate Credit facilities to stabilize credit markets.

While today's yield environment remains near historical lows, if an investor's fixed-income assets can generate an extra 150 basis points per year over a 28-year period, that adds up to quite a sum (see Exhibit 8). With asset class return expectations currently being rather modest, it's more important than ever to seek out all incremental sources of return. And that's where active management in fixed-income comes into play.

Exhibit 8: Growth of $10,000; Monthly Returns Jan. 1993 Through Dec. 2020



Source: Bloomberg Barclays, Western Asset. As of 31 Dec 20
Past performance is not indicative of future results. Please see Performance and Risk Disclosure for more information.

The Bottom Line

With investors worldwide scrambling for consistent income sources, fixed-income continues to deliver a reliable income stream—albeit at historically lower levels. It's important to keep in mind that markets can reset quickly and that includes fixed-income assets (nominal yields and spreads).

Fixed-income very much still matters to investors as it provides (1) diversification, (2) efficient returns per unit of risk, (3) an important source of total return (even when some market participants question its ability to deliver), (4) the ability to mitigate drawdown risk in stressed markets and (5) a much-needed and consistent income stream in today's low-yield environment.

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Asset-Backed Securities: The timing and size of the cash-flow from asset-backed securities is not fully assured and could result in loss for the strategy. These types of investments may also be difficult for the strategy to sell quickly.

Bonds: There is a risk that issuers of bonds held by the strategy may not be able to repay the investment or pay the interest due on it, leading to losses for the strategy. Bond values are affected by the market's view of the above risk, and by changes in interest rates and inflation.

Counterparties: The strategy may suffer losses if the parties that it trades with cannot meet their financial obligations.

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Currency: Changes in exchange rates between the currencies of investments held by the strategy and the strategy's base currency may negatively affect the value of an investment and any income received from it.

Derivatives: The strategy makes significant use of derivatives. The use of derivatives can result in greater fluctuations of the portfolio's value.

Emerging Markets: The strategy may invest in the markets of countries which are smaller, less developed and regulated, and more volatile than the markets of more developed countries.

Hedging: The strategy may use derivatives to reduce the risk of movements in exchange rates between the currency of the investments held by the strategy and base currency of the portfolio itself (hedging). However, hedging transactions can also expose the portfolio to additional risks, such as the risk that the counterparty to the transaction may not be able to make its payments, which may result in loss to the strategy.

Inflation: The value of bonds held by the strategy that are intended to protect against inflation may be negatively affected by changes in interest rates.

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Liquidity: In certain circumstances it may be difficult to sell the strategy's investments because there may not be enough demand for them in the markets, in which case the strategy may not be able to minimise a loss on such investments.

Low-rated Bonds: The strategy may invest in lower rated or unrated bonds of similar quality, which carry a higher degree of risk than higher rated bonds.

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