INSIGHT

THE GREATEST WEALTH IS **YOUR PEACE OF MIND...**

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Thinking sensibly about bonds

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If we had been given £10 for every article or commentary that we have recently read suggesting that a 60/40 balanced portfolio[1], or bonds as a whole, are 'dead', we would be most pleased! So why all the doom and gloom? Well, the world feels unsettled, inflation is high, the Pound is falling in value and both equities and 'safe' bonds are down. That makes investors feel uncomfortable. Yet this short-term negative sentiment belies some relatively positive news that has not been reported on:

- First and foremost well-diversified, sensibly structured global 60/40 balanced portfolios are down less than 5% this year (to the end August)[2], considerably less than most investors might expect and well within the bounds of expectation for such portfolios. Remember that it is this very uncertainty of outcome that underpins long-term risk premia.
- Global value stocks are actually up in both developed and emerging markets in 2022 helping to support portfolio values for those holding above-market-weight allocations, as most clients do.
- Lower levels of equity markets today mean higher expected returns from this point forwards.
- The fall in Sterling – which should really be viewed as a rise in the US dollar against most major currencies – has contributed positively to portfolios as unhedged US assets, in particular, are now worth more in Sterling terms.
- Global bonds now deliver investors yields between 3% and 3.5% across a number of major bond markets (UK, Australia, US) instead of next-to-nothing 18 months ago. Surely that is much better news?
- This higher yield now provides a cushion against any further price falls if yields rise further. When yields are at 0%, all yield rises will result in negative returns on bonds, as we have experienced in 2022.
- Last and most importantly, these materially higher yields on bonds make funding future liabilities - such as monthly income drawn from your portfolio - easier. Longer-term investors should be pleased. We explore this idea a bit further, shortly.

Sensible reasons for owning bonds

Investors' portfolio structures are put under the spotlight as times of market downturns, and in 2022 it has certainly been bonds in the beam. It can help to go back to first principles and ask why an investor owns them in the first place. The reasons are simple:

- They are far less volatile – particularly shorter-dated, high quality bonds – than equities. If equity markets fell by a half – which they have done from time to time - then bonds, even if they fell marginally would help to support portfolio values.
- In general, but not always (as we have experienced 2022), bonds have a low or negative correlation – i.e. moving differently - to equities, particularly in extreme equity markets. That can help smooth a portfolio's return journey. There are several examples of when bonds have fallen at the same time as equities, such as 1994. This does not mean they no longer 'work'. Investing is an imperfect science, but longer-term investors can take advantage of the generalities sensibly assigned to different asset classes to build better long-term portfolios.
- Bonds provide a source from which portfolio withdrawals can be made at times of equity market extremes, without the need to sell equities.
- In some circumstances they can be used to match specific known future liabilities, reducing the risk of not being able to meet the liability.
- Bonds have a higher expected return than holding cash, which is simply part of the fixed income spectrum. Both represent lending your money to a government or company, generally banks in the case of cash. Today, short-dated bond yields are higher than cash yields. Attempting to time when to jump between cash and bonds is not a game that long-term investors should play, as bond prices already incorporate all investors forward-looking views of what the future might hold, not least where the market thinks yields should be. Doing so will, by definition, be based on guesswork.
- Bonds (and cash) have a lower expected return than equities by about 3% to 4% p.a. It is important to remember that the actual returns gathered from equities, on an annual basis, will fall in a wide range around the average, which is why most investors own some bonds in the first place!

Bond yields and future liabilities

Like pension funds and other institutional investors, private investors have their own balance sheet of assets (investable portfolio, family home etc.) and liabilities (future cash flows they need or wish to meet). Unfortunately the financial media only ever seems to report on the asset side of the balance sheet. 'Bonds are down!'. Yet that entirely misses the point that bond prices fall because yields rise, and yield rises mean that liabilities fall[3].

Let's look at a very simple example, ignoring inflation and taxes to illustrate this. Imagine that you want to make a gift in 20 years' time to someone of £10,000. You place that money in a deposit account to make sure it is there when the time comes. When yields were 0% you would have needed to hold a deposit of £10,000 to meet this liability. However, with yields at 3% you would only need to place a deposit of £5,537, as the 3% interest would compound up over time to reach £10,000. Each cash flow in an investor's financial plan is a similar liability that needs funding and, despite asset values falling, the ratio of assets to liabilities has recently improved significantly for many investors. That certainly is a good thing.

The quote attributed to Mark Twain that 'The reports of my death are greatly exaggerated' could just as well be referring to bonds.

End notes

1.
60% in equities and 40% in bonds.

2.
Examples for educational purposes only include Vanguard LifeStrategy 60 Equity Fund in GBP or Dimensional World Allocation 60/40 Fund (not recommendations).

3.
A pension fund or individual investor's liabilities are usually calculated as a present value by taking all of the liabilities and discounting them back to today's value using a discount rate, which may be a government or corporate bond yield. When discount rates rise the present value of the cashflows decrease.

Other notes and risk warnings

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