4Q 2016 Market Insights
Bond Portfolios in Low Yield Environments
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"Know what you own, and know why you own it." - Peter Lynch

Over the past month, I have been fortunate enough to spend time with many of our clients and partners at several different business events across the country. At each stop, I spoke on a variety of investment topics, running the spectrum of assets from equity to fixed income, and from the US to the emerging world. While I received a variety of questions, one question was consistent at every stop. "With ten-year treasury yields at 1.5%, what should investors do about their bond portfolios?" Admittedly, this is a real challenge and an unintended consequence of Quantitative Easing. That is, while the economy got a boost, the Fed did so at the expense of savers. This includes all who are investing to fund a liability, individuals saving for retirement and other life goals, endowments and foundations, and especially pension plans. The real rub for the individual investor is how do you own an asset with such a low return and manage to grow your nest egg or draw enough income from it to retire? This quarter's Market Insights will address these points by speaking to *Bond Portfolios in Low Yield Environments.*

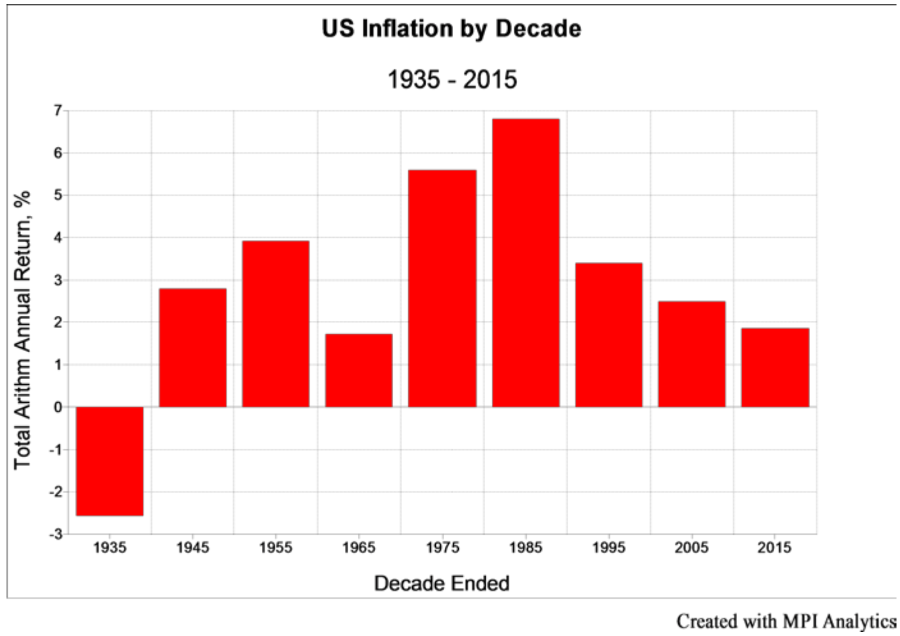
Treasury Bonds

For those that follow our research, it isn't much of a secret that we believe high valuations will depress US equity returns for the better part of the next decade. However, the fixed income side of the portfolio is where things become really interesting. Not only is fixed income an important asset within a diversified portfolio, but I would argue that its role as a return generator is actually secondary. The primary role of fixed income is to act as a conservative anchor. It is there to water down equity risk to a level that is palatable to the investor, as well as provide an asset that generally holds its value, or appreciates, when equities decline. Additionally, bonds can serve as a store of value and a source of funds to rebalance into equities at low prices. While some would argue that income is important, especially for those drawing from a portfolio, there are ways to get income other than just bond yield. Its return, while important, is less critical than its role as life preserver.

Despite what bond market doomsdayers will have you believe, historically bad bond markets pale in comparison to bad equity markets. That is, they are much less severe by comparison. As evidence, I offer the drawdown and recovery statistics for both stocks and bonds. For those that aren't familiar, a drawdown is simply a period of decline. In particular, we are interested in the maximum period of decline for the S&P 500 compared to the Barcap Aggregate Bond Index, the duration of the decline, and how long it took to recover peak value. In this race to the bottom, stocks lose hands down on virtually every downside statistic. When comparing the worst twenty-four months on record for each asset, stocks experienced a maximum decline of 45.36%, while bonds lost just 6.09%. The maximum decline for equities without any limit on the timeframe was over 50% and took 37 months for stocks to recover from their trough. By contrast, the maximum decline for bonds was just shy of 13% and losses fully recovered within just 3 months. History without the context valuations; hogwash you say! Kudos to you. I would say the same thing (I'll get to valuations momentarily).

Unlike the rest of the world, we are really not overly bearish on fixed income. However, at the same time, it's equally difficult to be really excited or bullish on the asset class…the reason being valuations. To us, every non-risk bearing fixed income instrument prices based on some assumption of what inflation will be over the horizon of the bond, plus a real return premium. That premium on the 10-year treasury has historically been about 75bps above inflation. Admittedly, in a low yield environment, that will probably become compressed. When you frame treasuries in the context of an expected rate of inflation that is priced into the bond, plus a required real return, it becomes easier to understand our apathy, but also our lack of overwhelming concern. Allow me to explain. The yield on the 10-year treasury is approximately 1.5%. For treasuries to provide a real return that is even remotely close to the historical average of 75bps, inflation needs to be below 1% for a decade. That's pretty close to deflation. As seen in the chart on this page, inflation typically hovers somewhere between 2-3%. So while the market has probably underpriced inflation, the question is by how much? The likely answer is in the range of 1-2%. Therefore, if inflation ends up being 3%, then rates would need to climb to 3.5% to 3.75% to provide enough cushion for that real return premium. In that scenario, bonds would lose approximately 14%, when accounting for the declining price and offsetting yield. Bad? Certainly. In fact, this decline is in-line with some of the worst bond markets on record. But, nowhere near as bad as poor equity markets. Fearing bonds by running to equities is like trying to hide in the lion's den because you hear a roar somewhere nearby.

US Consumer Prices



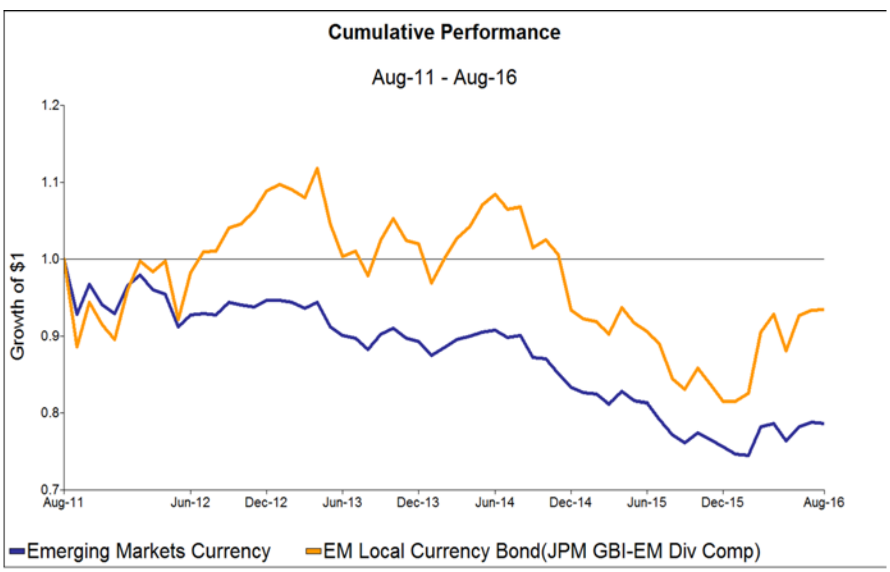
Since 1926, there have been nine complete decades. Five have produced inflation rates of below 3%, two have fallen between 3-4% and only two have exceeded 5%. Of the two that were above 5%, if we break them down into 5-year periods we find that the entire decade of the 70's produced above 5% inflation but haven't exceed that level since.

Credit, TIPS Bonds & Other Non-Treasuries

Over the past few years we've stated on numerous occasions that the pricing of the risk-free asset affects the pricing of all other assets. To a certain degree then, our comments on anything following treasuries needs to be taken in context. For US bond market segments, all other assets price in relation to the comparable treasury. Therefore, if we find something attractive, it's a relative comparison. A rise in treasury yields will certainly negatively impact credit, mortgages, TIPS, and really all other assets. In our view, if the asset is undervalued, it provides a better return opportunity over the long run. This is our focus, the long run return opportunity. On a relative value basis, credit is reasonably priced. The risk here relates to the financially engineered economic recovery in the US. On that basis, in our opinion, the interest rate risk discussed in the prior section is secondary. The risk embedded in corporate bonds is related to our economy, as well as the chance that investors will lose their appetites for risk all together. It is, however, unlikely that rates move higher and spreads widen. The exception to that statement is if the Fed hikes rates first and then spreads widen in anticipation of a poor economic climate, or at least a riskier one. In either scenario, we are really reluctant to take any sizeable credit risk, despite the allure of junk bond yields. Therefore, we view investment grade credit somewhat favorably and below-investment grade credit very skeptically. Defaults have risen from lows, but bonds have not done nearly enough to price in a normal cyclical increase in defaults, much less a shock to credit markets like we experienced in the latter 1990's or 2008.

Like credit, Treasury Inflation Protected Securities (i.e. TIPS bonds) offer some marginal benefits beyond the nominal bond. For those that aren't familiar, TIPS are essentially a treasury bond with one notable difference. That is, instead of knowing what your exact income payment will be at the time of purchase of the traditional treasury bond, investors in a TIPS bond only know the real return at purchase. In addition, they receive an inflation credit after the fact. In essence, the nominal bond pays a fixed rate, while the TIPS bond is variable based on inflation. Since the market has likely underpriced inflation, at least by a little, that makes the traditional nominal treasury a rather poor deal and the TIPS bond a better buy. Consider the following simple example. If the nominal Treasury bond yields 1.5% and inflation is 2%, what is your real (after inflation) return? Answer; negative 0.5%. But simultaneously, if the TIPS bond is quoted at a real yield of 10bps, an investor in the TIPS bond would receive 2% for inflation plus 10 bps or 2.1%. If inflation was 3%, an investor would receive 3% + 10bps or 3.1%. Essentially, when an investor believes that the bond market has underpriced inflation, the TIPS bond becomes the better buy, as we believe it has today.

Emerging Markets Bonds & Currency



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Over the past 5 years, Emerging Markets Local Currency Bonds have declined by nearly 20%. The currency has contributed more than 100% of that loss, declining by 25%. Said differently, other characteristics of the asset, including the coupon, partially offset the effects of the weakening emerging markets basket of currencies. Today, emerging currencies are near historically undervalued levels relative to the dollar. This should provide a tailwind to the asset.

The final opportunity I'll address within the scope of this article requires extending one's vision beyond US markets. While foreign investing has become more commonplace within fixed income than it was 10 years ago, it still carries with it a home country bias, perhaps even more prevalent than in equity space. Since foreign developed markets' central banks are engaging in quantitative easing and negative interest rates in order to jump start sagging economic output, their bonds provide little help in diversifying a lackluster domestic fixed income portfolio. The emerging world, however, provides some interesting opportunities. In fact, it was a perfect storm of negative events that took us, here. It is the unsustainable nature of these events as they reverse that serve as the opportunity, most specifically currency. As the US dollar strengthened, this took its toll on all non-dollar denominated assets, including emerging markets local currency debt. As we have seen so far this year, a small upward move in the currency has allowed the fundamentals of this asset to shine through, as emerging markets local currency bonds have advanced by over 17% through September of this year. With attractive yields, a brighter backdrop for commodities (many emerging nations are sensitive to commodities prices), and a more favorable currency backdrop, we are exceptionally optimistic about the asset class.

Summary

Ironically, 12 months ago many investors found themselves in the position that we see ourselves in today. That is, staring down the barrel of what they thought were imminently higher interest rates, yet as we speak, rates are nearly 0.75% lower now than they were a year ago. While I would caution bond market bulls that a repeat is exceptionally unlikely, I would also caution bears that the chances of a bond market Armageddon are remote. The prospect of higher rates and a potential loss of principal are both scary possibilities for those who seek shelter in bonds. However, in our view, the real mistake is fearing the growl of an angry bond market and running into the equity lion's den. Remember, it would take a real outlier event to cause a substantial sell off in bonds. Not so with equities. In fact, it's probable, at some point, for US equities to face a headwind as multiples contract. The severity and pain depends on how abruptly they contract, not if they will. If this occurs over years, investors will experience reduced, but positive equity returns. However, if equity multiples contract quickly, that's the stuff from which bear markets are made. While the prospects for fixed income are somewhat lackluster to say the least, we liken this environment to a baseball team that hits single after single, pitches, and plays good defense, as opposed to the team that swings for the fences. This environment is not a homerun environment without taking on sizable risk. We can't justify, nor will we support, such a tactic.

We opened this article with a quote from Peter Lynch, the longtime Fidelity Magellan fund manager and legendary investor. "Know what you own, and know why you own it." Bonds are, first and foremost, the conservative anchor to a portfolio. That fact has not changed regardless of the level of interest rates. Thank you for your trust and confidence.