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Is now the time to reduce bond exposure?

The last 12 months have been a good reminder of how difficult it can be to accurately predict and time interest rate moves. For instance, after the surprising outcome of the Brexit vote in June last year, the 10-Year U.S. Treasury Yield hit a multi-year *low* of 1.4% in July. But following the unforeseen result in November's U.S. Presidential election, interest rates *rallied* —by mid-December the 10-Year yield had reached 2.5%. Going into 2017, rates were broadly expected to continue rising. Instead, the opposite has happened: The 10-year yield has *dropped* approximately 25 basis points year-to-date as of June 12. Investors who attempted to reposition their portfolios in anticipation of interest rate moves prior to last year's elections likely got whipsawed.

This is why I get concerned when investors question the value of fixed income in their portfolio anytime interest rates are expected to rise. Yes, when interest rates go up, the price of bonds goes down. However, there is more to investing in bonds than that:

1. Bonds are a primary diversifier for equities
2. In long-term investing, it's the total portfolio outcome that matters—not the short-term movements of individual asset classes.

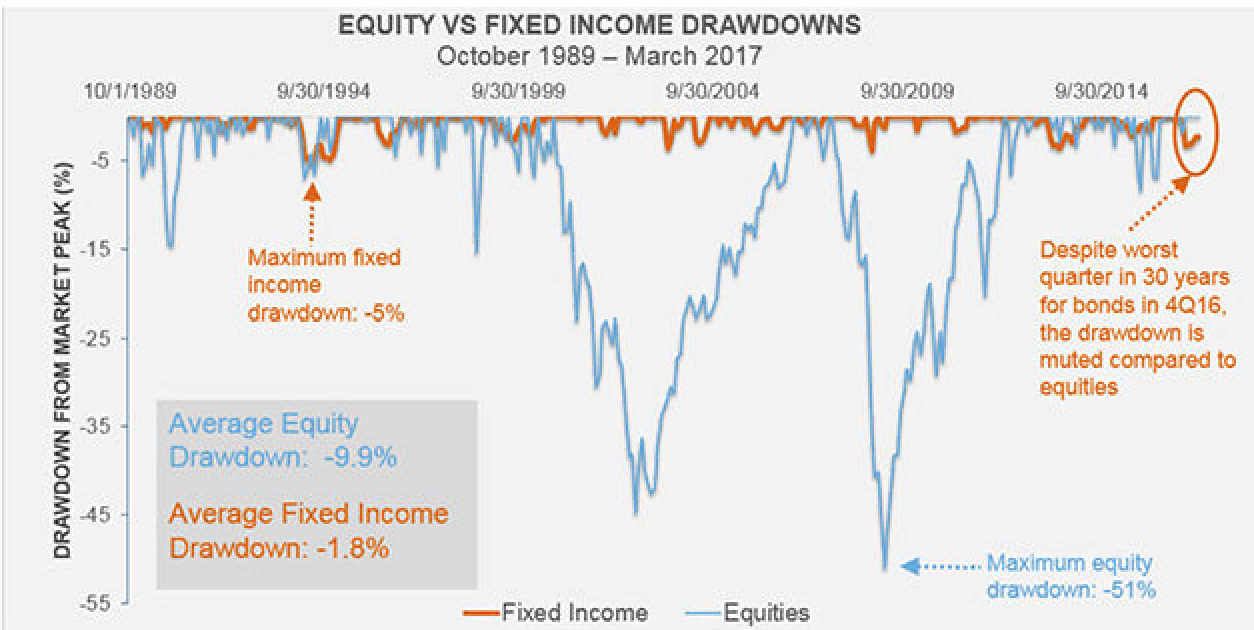
Let's take each of these points in turn.

Bonds are a primary diversifier for equities

Most investors understand that equities are the primary driver of portfolio growth and that bonds are the primary risk reducer. But it can be easy to overlook the risk management benefits of bonds, depending on the prevailing capital market environment. In particular,

- during periods of prolonged equity rallies—because who feels they need downside protection when everything is marching upward by leaps and bounds?
- or when interest rates are expected to rise—because who wants to invest in an asset that is mathematically guaranteed to lose value under that scenario?

For those investors, the chart below may be a helpful reminder of the relative risks of stocks and bonds.



Source: Morningstar monthly max drawdown % for the Bloomberg Barclays U.S. Aggregate Bond Index ("Fixed Income") & the S&P 500 Index ("equities") from 10/1/1989 to 3/31/2017. Indexes are unmanaged and cannot be invested in directly.

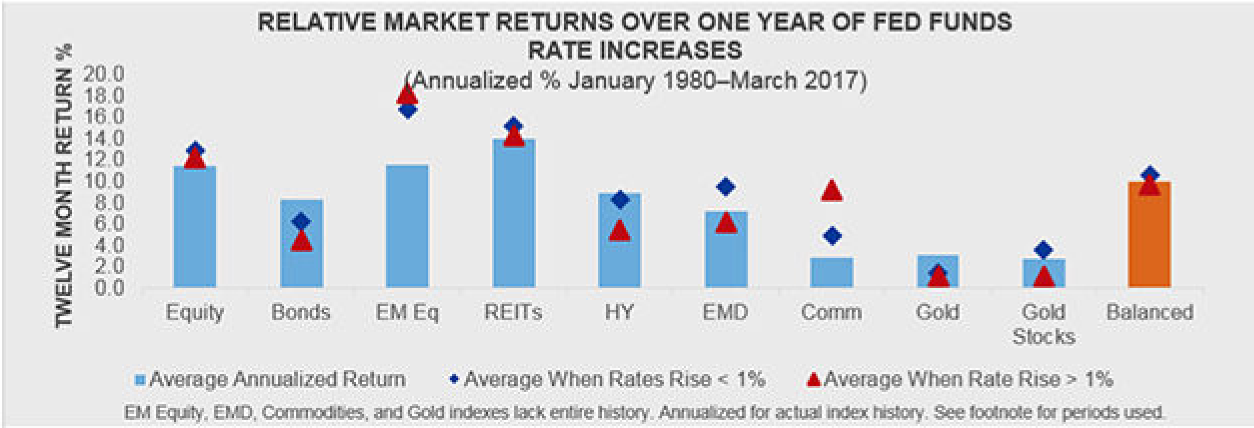
As the chart shows, bonds (Bloomberg Barclays U.S. Aggregate Bond Index) have a different return pattern than stocks (S&P 500® Index)—and bonds have been much less volatile than stocks:

- Over the 30 years ending March 2017, the largest drawdown in fixed income was -5%. The *typical* fixed income drawdown was less than -2%.
- Equity drawdowns dwarf those bond losses: The typical equity drawdown over the 30 years ending March 2017 was -10%. Shrink that time frame to 20 years ending March 2017 and the equity drawdowns are even more stark: greater than -40% and -50%.

So, investors are typically glad to hold bonds when equities correct. What's more important, though, is that investors *should always* hold bonds in alignment with their individual risk tolerance because it's impossible to predict *when* equities will correct.

The importance of taking a total portfolio view

It's true that bond returns lag their historical averages during periods of rising interest rates. That's simply how bonds work: Interest rates go up and bond prices go down. However, bonds are only one component of a total portfolio. A typical balanced portfolio also includes investments in global stocks, emerging markets stocks, real estate, commodities, high yield bonds, to name a few. It's the interaction and return of *all* of these asset classes together that matters—and what investors should focus on.



Source: Equity: MSCI World Index, Bonds: Bloomberg Barclays Aggregate Bond Index; EM Eq: MSCI Emerging Markets Index (Jan 1988 - Mar 2017); REITs: FTSE NAREIT Equity Index, High Yield: BofA Merrill Lynch U.S. High Yield Index; EMD: JP Morgan Emerging Markets Bond Index (Jan 1992 - Mar 2017); Commodities: Bloomberg Commodity Index (Feb 1991 - March 2017); Gold: Bloomberg Commodity Gold Index (Feb 1991 - Mar2017); Gold Stocks S&P Gold Stock Index; Balanced: 50% Stocks, 30% Bonds, 5% REITS, 5% High Yield, 5% EM, 5% CommoditiesIndex returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

The above chart shows how some of the most common asset classes have historically behaved during periods of rising interest rates. As expected:

- Equities tend to do better than their average—because interest rates typically rise when economic growth is positive to strong.
- Bonds tend to do worse than their historical averages (but not negative) during rising rate periods.

Other asset classes have had more mixed results. But the **most important relationship** is that of the hypothetical total (balanced) index portfolio. Its performance has hovered around average historical results when interest rates have increased. It's the balance of stronger than average equity returns and weaker than average bond returns—i.e. *diversification*—that helps create this outcome. Of course, diversification doesn't protect against all loss or guarantee a profit, but hopefully it provides investors with some comfort that they don't need to "take action" in periods of anticipated rate increases.

The bottom line

It's easy to understand why investors may want to reduce their fixed income exposure when faced with rising interest rates. Unfortunately, correctly determining the timing and direction of interest rate moves can be very difficult, if not impossible. In addition, hypothetical diversified index portfolios have traditionally held up well during periods of rising rates, removing some of the justification for trying to avoid bonds in those environments.

Ultimately, it comes back to time-tested investment best practices: 1) select an asset allocation that matches investor risk tolerance and 2) have the conviction to maintain that discipline even when you're tempted to deviate from the course.

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Bloomberg Barclays U.S. Aggregate Bond Index: An index, with income reinvested, generally representative of intermediate-term government bonds, investment grade corporate debt securities, and mortgage-backed securities. (specifically: Barclays Government/Corporate Bond Index, the Asset-Backed Securities Index, and the Mortgage-Backed Securities Index).

The S&P 500® Index is a free-float capitalization-weighted index published since 1957 of the prices of 500 large-cap common stocks actively traded in the United States. The stocks included in the S&P 500® are those of large publicly held companies that trade on either of the two largest American stock market exchanges: the New York Stock Exchange and the NASDAQ.

MSCI Emerging Markets Index: A float-adjusted market capitalization index that consists of indices in 21 emerging economies: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

FTSE NAREIT all Equity Index: Measures the performance of the commercial real estate space across the U.S. economy offering exposure to all investment and property sectors.

BofA Merrill Lynch U.S. High Yield Index: Tracks the performance of USD-denominated below investment grade corporate debt publicly issued in the major domestic markets.

JPM Emerging Market Bond Index (EMBI): dollar-denominated sovereign bonds issued by a selection of emerging market countries.

Bloomberg Commodity Index Total Return: Composed of futures contracts on physical commodities. Unlike equities, which typically entitle the holder to a continuing stake in a corporation, commodity futures contracts normally specify a certain date for the delivery of the underlying physical commodity. In order to avoid the delivery process and maintain a long futures position, nearby contracts must be sold and contracts that have not yet reached the delivery period must be purchased. This process is known as "rolling" a futures position.

Bloomberg Commodity Index Family: Represents the major commodity sectors within the broad index: Energy (including petroleum and natural gas), Petroleum (including crude oil, heating oil and unleaded gasoline), Precious Metals, Industrial Metals, Grains, Livestock, Softs, Agriculture and ExEnergy. Also available are individual commodity sub-indexes on the 19 components currently included in the DJ-UBSCI?, plus brent crude, cocoa, feeder cattle, gas oil, lead, orange juice, platinum, soybean meal and tin.

The S&P Gold Stock Index: Gold company stocks held within the S&P Index series. The stocks included in the S&P Index series are those of publicly held companies that trade on either of the two largest American stock market exchanges: the New York Stock Exchange and the NASDAQ

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