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Are Investment-Grade Bonds Still Worth Holding?

FEBRUARY 2021

Portfolio Strategies Group

Snapshot

- Low interest rates and high prices have caused some investors to question the appeal of investment-grade bonds.
- Are they worth the risk? Do they still provide diversification benefits?
- We believe the answer to both questions is, 'Yes.'

With investment-grade bond yields at historic lows, it's not surprising to hear investors express concerns about the effectiveness of fixed-income allocations in a strategic portfolio. Some investors have even questioned whether it's time to abandon investment-grade bond allocations altogether. While an understandable consideration given the historically low rates and narrow spreads, our answer is a resounding 'No.'

We believe that investment-grade bonds will continue to offer a combination of better returns than cash (positive risk premium) and genuine diversification benefits relative to equities. In our view, those diversification benefits are particularly notable since equity risk typically dominates investors' portfolios. If the economic recovery out of the current pandemic were to falter, we think exposure to bonds could help mitigate harm caused by a drop in stock prices. On the other hand, if economic growth strengthens, we would expect investment-grade bonds to hold their value given the outlook for continued low interest rates as a result of efforts by global central banks to support the economic recovery.

Let's take a closer look at investment-grade bonds both as a standalone investment and as a component of a diversified portfolio.

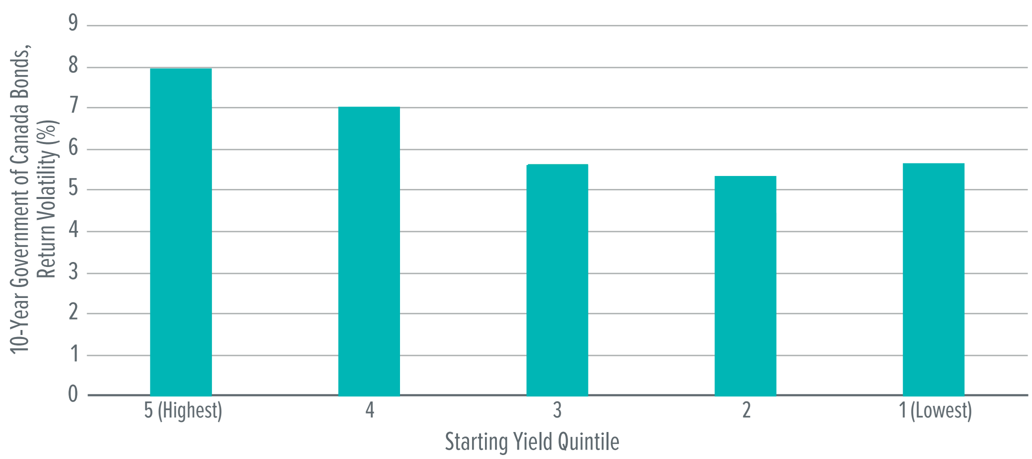
Asset-class risk: standalone investments

When considering investment-grade bonds as a standalone investment, an increasingly common fear among investors is that low interest rates (which result in low yields) will undermine their investment from both risk and return perspectives. Put another way, investors are questioning whether the now-paltry expected returns are worth the usual risk that a bond issuer may default and fail to repay the loan. We would make the case that the expected return relative to stocks appears unchanged and, therefore, the relative attractiveness of each asset class remains the same.

There is no clear indication that return assumptions today are any different than they have always been—with investment-grade bonds (as measured by the FTSE Canada Universe Bond Index) historically expected to return about 1% to 2% more than cash (the return on cash is often referred to as the short-term risk-free rate) on an annualized basis, and stocks (as measured by the S&P/TSX Composite Index) expected to return roughly 5%-6% more than cash. In addition to risk premiums (excess return expectations above the cash rate) remaining the same, expected total returns (the return that includes interest payments and changes in principal) have lowered across all asset types at roughly the same pace. This would imply that the relative attractiveness of each asset class remains the same; that is, the rewards for taking risk, over and above the risk-free rate, have not significantly changed.

With seemingly nowhere to go but up, do low interest rates mean bond returns will be more volatile than they have been historically as rates begin to rise? We can assess this by examining interest-rate risk, a measure of potential portfolio losses when interest rates rise that is a function of both duration and the volatility of yields themselves. History suggests that while lower rates imply higher duration, yield volatility actually tends to decline as the level of yields declines. Exhibit 1 illustrates this point using 10-year Government of Canada bonds as an example; similar experiences can be seen in bond markets throughout the developed world.

Exhibit 1: Lower-Level Yields Tend to Be Accompanied by Lower Return Volatility



Source: Bloomberg, SEI. Data spans 1/1/1985 to 12/31/2020. Starting yield quintiles divide the data set into equal groups based on starting yield; those with the highest starting yield are placed in quintile 5, while those with the lowest starting yield are in quintile 1.

While a sharp move higher in yields would reduce bond prices in the near term (prices and yields have an inverse relationship), it would also improve the reinvestment outlook (as bonds mature, investors can purchase new bonds that offer a higher rate of interest) and increase expected longer-term returns. Exhibit 2 utilizes U.S. data (based on the better availability of historical data), but we believe the chart illustrates concepts that transcend geography. Perhaps somewhat counterintuitively, a rising-rate environment could be the most beneficial of the potential outcomes over a longer-term horizon.

Exhibit 2: What Might Bond Yields Look Like in the Future?

Today		10 years later: Scenario A "Lower for Longer"	10 years later: Scenario B "Rising Rates"	10 years later: Scenario C "Falling Rates"
Yield	1.1%	1.1%	3.6%	0.0%
Coupon Rate	2.8%	2.8%	4.5%	2.0%
Average Maturity	8 years	8	8	8

Source: SEI DataPortal, ICE BofA. Data as of 12/31/2020. Future metrics for yield, coupon rate, average maturity and slope of the yield curve are hypothetical and for illustrative purposes only. Current metrics for yield, coupon rate and average maturity are indicative of the Bloomberg Barclays US Aggregate Bond Index. Slope of the yield curve is indicative of the AA corporate yield curve (10-year yield minus 5-year yield). All metrics are assumed to move linearly from the current metrics to the future metrics over the course of ten years.

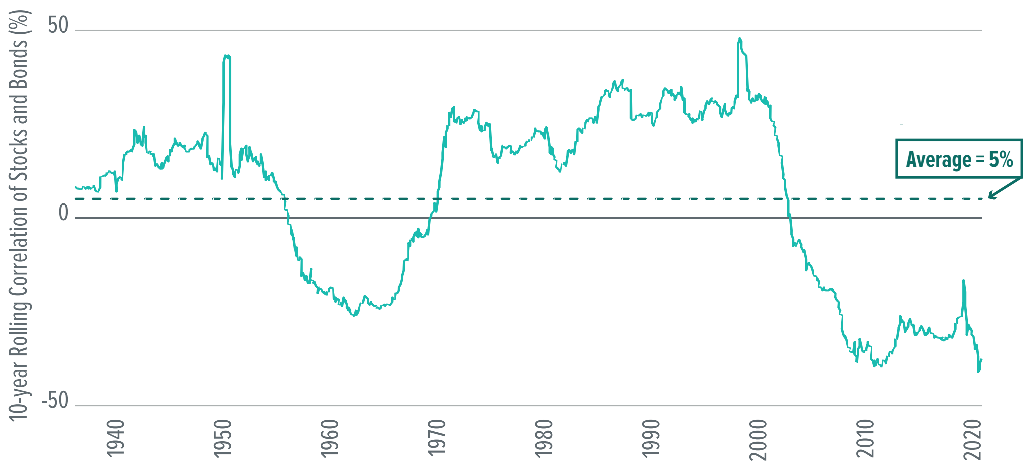
Portfolio risk

When rates fall further and further, fixed-income returns are often challenged. As the price of a bond climbs higher, the fixed coupon payment (paid to investors in the form of interest) becomes smaller by comparison. This leaves investors subject to "reinvestment risk"—that is, when proceeds from maturing bonds are reinvested in a less favourable environment of higher prices and lower yields. Investors in this scenario commonly wonder whether bonds are too richly valued to fill their traditional role of portfolio diversifier.

However, in a world of low or negative short-term interest rates, we believe it is reasonable to view valuations as elevated across all financial assets (including stocks and bonds). As a result, forward-looking expected returns would likely be lower across the board—not just for fixed-income investments. So the question then becomes, "Are correlations between bonds and riskier assets such as equities still low enough to provide diversification benefits?"

Historical data show that the correlation between bonds and equities tends to remain low in periods of stress—and, in many cases, actually falls. As in the previous chart, we utilize U.S. data (based on the better availability of historical data) for Exhibit 3. We believe this demonstrates that investment-grade bonds are one of the few asset classes that are genuinely diversifying to equities.

Exhibit 3: Bonds Have More to Offer than Just Their Return



Source: Morningstar, SEI. Based on monthly returns from 1/1/1926-12/31/2020. Stocks = Ibbotson Associates SBBI U.S. Large Stock Index, Bonds = Ibbotson Associates SBBI U.S. IT Government Index. Average of rolling 10-year correlations over the entire data series is approximately 5% and is represented by the dotted line.

Diversification: first, last, always

We realize low yields don't excite anyone. We are also well aware that diversified portfolios are unlikely to make the list of the year's top performers. Still, we firmly believe that seeking to maximise returns and minimise risks is the right way to approach portfolio construction. Accordingly, we'll be holding on the bonds in our strategic allocations.

Glossary of Financial Terms

Duration: The change in a bond's price given a change in interest rates.

Index Definitions

Bloomberg Barclays US Aggregate Bond Index: a benchmark index composed of U.S. securities in Treasury, government-related, corporate and securitized sectors. It includes securities that are of investment-grade quality or better and have at least one year to maturity.

FTSE Canada Universe Bond Index: a benchmark index used to measure the performance of fixed-rate, investment-grade domestic government and corporate bonds denominated in Canadian dollars.

Ibbotson U.S. Large Company Stock Index: a benchmark index that measures large company stocks. It is represented by the S&P 500 Composite Index (S&P 500) from 1957 to present, and the S&P 90 from 1926 to 1956.

Ibbotson U.S. Intermediate-Term Government Bond Index: a benchmark index that is measured using a one-bond portfolio with a maturity near five years.

S&P/TSX Composite Index: a capitalization-weighted index that is the principal reference for Canadian equities markets. The index includes Canadian-based common stocks and income trust units.

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210086.02 FR (02/21)