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IN CONTEXT THOUGHT LEADERSHIP SERIES

USING THE TOOLKIT

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THE ROLE OF BONDS IN MULTI-ASSET PORTFOLIOS

Despite the significant size of many portfolio allocations to bonds, fixed income has long been a boring topic for most advisers and their clients. Historically a stable, low-risk investment, fixed income does not dominate headlines. It is not expected to generate big returns. Media do not run daily reports on the latest index levels reached by bonds. A quick check-in now and then to make sure yields are acceptable and that correlations remain low in equity down markets, and investment updates typically turn to more exciting topics.

For many advisers, this narrative has now changed with bonds increasingly a key feature of client portfolio discussions.

In today's market, the rosy narrative around fixed income is severely challenged. With interest rates at historic lows, many advisers know that we can no longer take for granted the two traditional portfolio roles played by bonds; income generation and risk mitigation. Indeed, we believe that the starting point for interest rates today, near or below 0% across most of the developed world, has also introduced a considerable amount of unintentional or unrewarded risk into an asset class that has generally flown under the radar in discussions about investor portfolios.

True, bonds as an asset class have enjoyed a very long bull run as rates have been driven relentlessly downward over a period of decades. The top of the market has been called before; to date, all takers for such a trade have proven wrong – witness the fate of two decades worth of investors shorting Japanese government bonds, a move colloquially known as "the widow maker".

Timing the market is an extremely challenging exercise, especially for fixed income where central bank manipulation and non-price sensitive participation is widespread. Instead, we advocate for a thorough, forward-looking consideration of the current macroeconomic environment, and the implications this has for robust portfolio construction.

On balance, we believe that one of the most constructive projects investors can undertake take today is to challenge allocations to broad, nominal bonds by breaking down their allocations to bonds into separate parts. The rest of this paper examines in more detail our reasons for advocating this approach, and how we go about building fixed income portfolios in response.

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INCOME

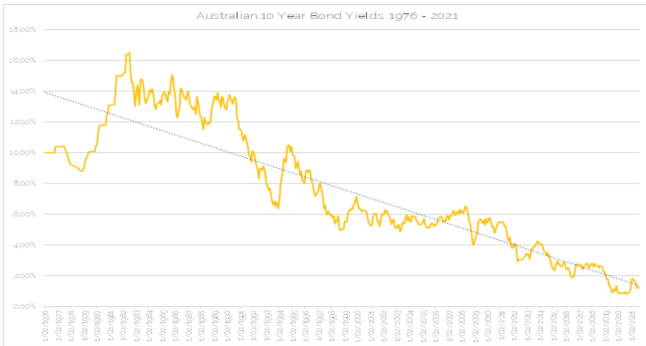
From a return standpoint, investors have generally relied on government and other very high-quality bonds to provide income, in the form of coupon payments. Bond prices vary throughout time as maturities shorten and prevailing yields move around, but capital gains are generally not what the asset class is about, with the expectation of certain active strategies such as those access the benefit of 'rolling down the curve'.

The income generated from holding bonds is determined by the interest rate environment at the time of a bond's issuance. As interest rates fall, the payments made for holding bonds decreases. Looking back over the past several decades, we see a clear, one-way trend in the direction of rates, both in Australia and other major markets.

The implications of this for investor's income returns are plain to see. Developed market interest rates are generally below 2% per year, which makes holding bonds a much less attractive proposition than when rates were at 5, 10, or even 15%. At an extreme, consider the case of the German 10-year bond, as seen above; rates on offer are currently less than 0, which means that investors buying German bonds are locking in a negative return if they hold their investment to maturity.

In such an environment it is apparent that we cannot count on our traditional sovereign and other high quality bond allocation to provide us with income, robbing our broader portfolios of an important source of total returns.

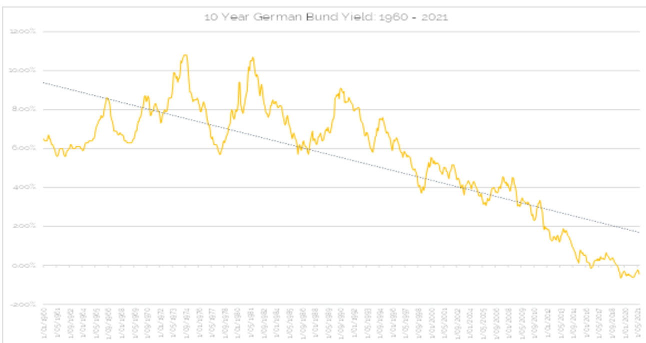
But at least we can still count on our bonds to provide some diversification and help to offset equity losses….right?



Source: au.investing.com

And across other major markets:

Source: St. Louis Federal Reserve



Source: St. Louis Federal Reserve

RISK MANAGEMENT

The mechanism through which bonds have traditionally mitigated risk in diversified portfolios is duration, which is simply the price sensitivity of a bond to changes in interest rates. The price of a bond and interest rates move in opposite directions, so as interest rates fall, bond prices increase.

In theory, bonds should offset equity losses because in bear markets, investors sell equity holdings to invest in "safe haven" assets like high-quality bonds. The increased demand for bonds drives interest rates down and bond prices up, helping to mitigate losses from shares.

It is clear to see that this process has a natural limit – as interest rates structurally lower, there is less and less room for them to fall further. Assuming there is a lower bound on how far rates can fall (acknowledging that this is debatable), eventually the ability for bonds to cushion equity losses becomes fundamentally impaired. Are we at that point today? It is impossible to say with certainty, although an examination of equity market drawdowns of greater than 10% over the last 20 years supports the thesis:

ASX Drawdowns Greater Than 10% [1]

Drawdown Period	Total Bond Return	Beta	Correlation	Down Capture	Avg. 10 Year Yield
June 2001 - Jan 2002	3.92%	-0.05	-0.18	-45.07%	5.75%
Jan 2002 - Oct 2003	10.42%	-0.21	-0.65	-53.56%	5.58%
Oct 2007 - Oct 2013	50.08%	-0.09	-0.44	-27.68%	4.77%
Feb 2015 - Jul 2016	6.15%	0.02	0.09	-9.43%	2.55%
Aug 2018 - Mar 2019	5.16%	0.05	0.27	-20.02%	2.05%
Jan 2020 - Mar 2021	-1.51%	-0.01	-0.1	-8.37%	1.03%

There is certainly at least an anecdotal empirical trend – as yields have declined, Australian bond correlation and beta (two measure of how investments move with each other) to equities have increased, suggesting that a pure reliance on bonds as an effective risk mitigant has become less effective.

A second, less appreciated, implication of the downward march of interest rates is the stealthy build up of duration risk in passive bond funds. It is a function of the mathematics of bonds that duration increases as yields fall; that is to say, bonds become increasingly sensitive to smaller and smaller changes as prevailing interest rates approach 0.

[1] The indices used to build this data are the S&P/ASX 300 TR Index and the Bloomberg Ausbond Composite 0+ Yr Index

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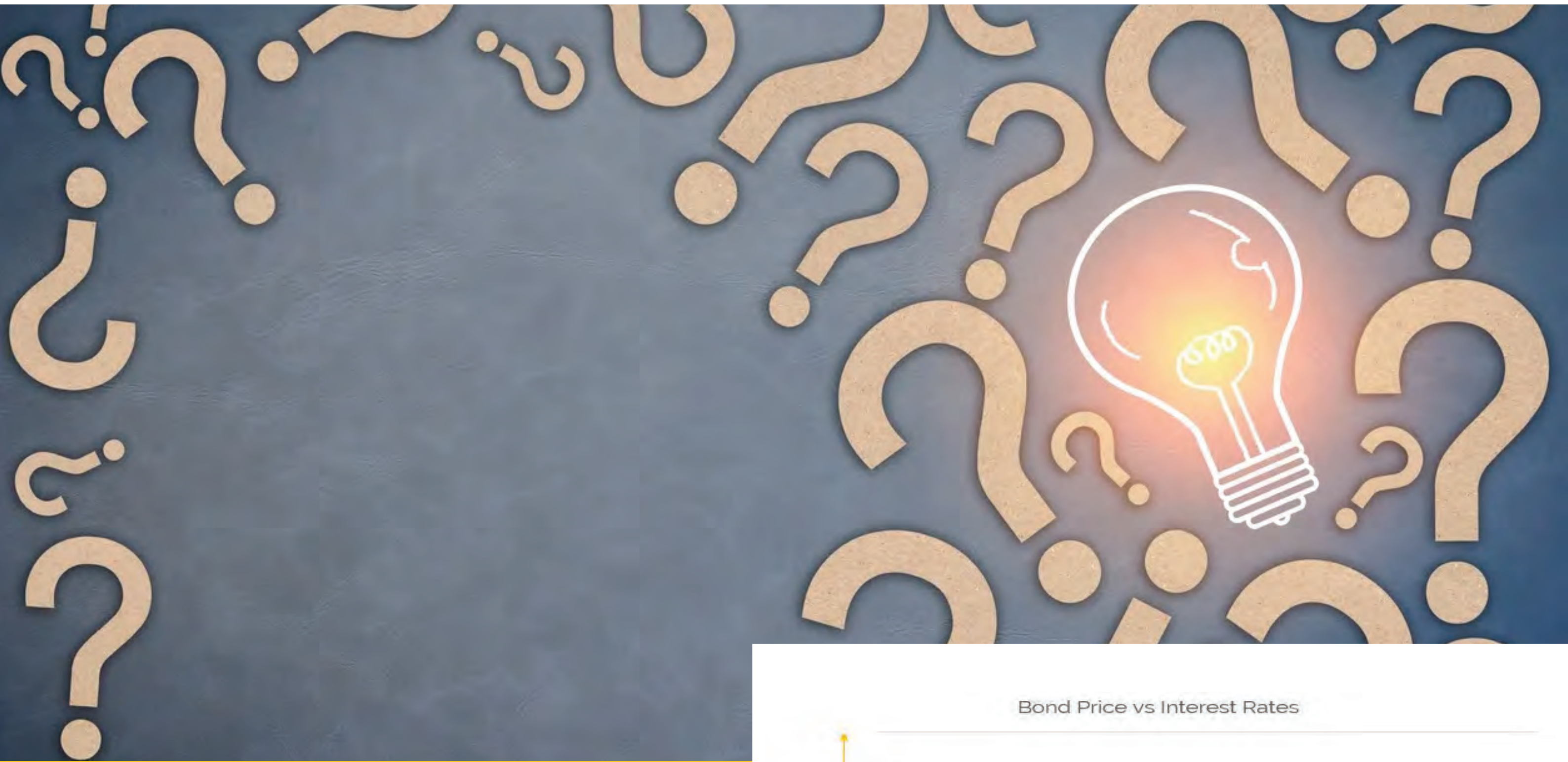

RISK MANAGEMENT

This concept is represented in the chart below, where we see the change in price of theoretical $10,000 bond with a 7% periodic payment as prevailing interest rise and fall:

Note the shape of the graph – as interest rates become lower, the steepness of the curve, which represents duration, increases; the boost we get in the price of this bond when rates move from 2% to 1% is much better than the increase when rates move from 15% to 14%. This is a neat picture of the effect of duration on price, and of the effect of rates on duration – convexity.

Now consider what this means in the context of today's environment. The ride for bonds on the way down has been excellent, but we now find ourselves in essentially a 0% rate world. As we've demonstrated in the graph above, this means that passive bond funds will, by default, be exposed to historically high levels of duration risk.

This creates two major issues. First, as we've already discussed, if rates cannot fall lower, there is no cushioning mechanism when equities fall. Worse, though, is a scenario where rates rise, whether due to inflationary pressure, the withdrawal of fiscal and monetary stimulus or some other scenario that we cannot foresee. Converse to the example above, the effect on bond prices if interest rates move from 0% to 1% is much worse than a move from 14% to 15%.

Consider a real-life example. The Bloomberg Ausbond Composite 0+ Yr Index, which many passive bond funds track, had a duration of 6 years as of August 2021. This implies that a 1% interest rate rise would lead to 6% loss for a fund tracking the index. A loss of that magnitude, from an allocation to bonds, is likely not something that most investors have even contemplated. And to be fair, in a more "normal" interest rate environment, they wouldn't have had to!

To summarise, we believe that the value proposition of traditional bond allocations is significantly challenged. We certainly aren't alone expressing this concern, so what can we do instead?

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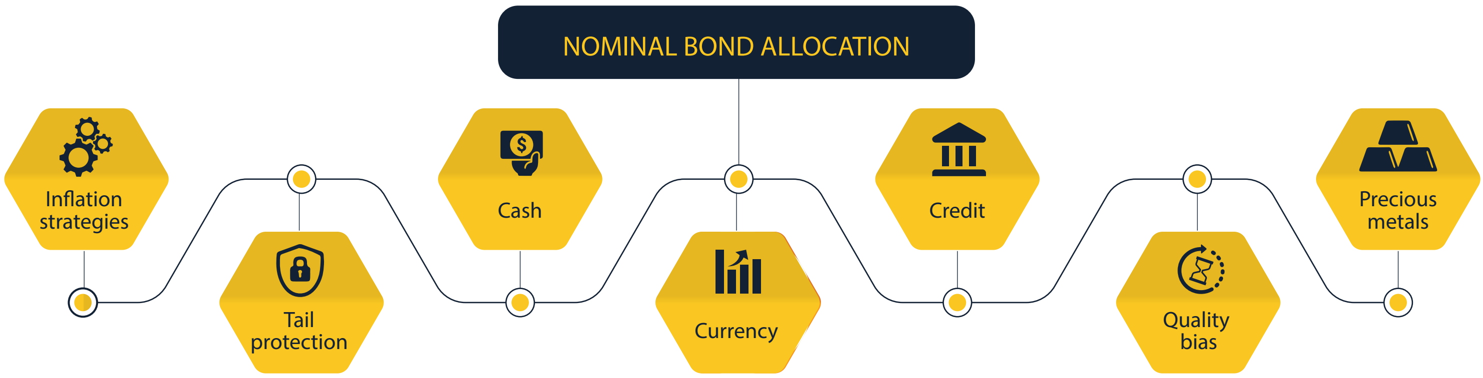
WHAT CAN WE DO?

In response to this specific portfolio construction challenge, we advocate for an active, disaggregated approach to fixed income.

By thinking about the asset class in its constituent parts, income and risk mitigation, we can use different strategies to fill the role that traditional bond allocations used to play – using the toolkit.

In our view, there is more than one way to approach the problem. For the reasons discussed above the one common theme for Context Capital, regardless of other factors, is a significant reduction to passive fixed income. While it can seem tempting to maintain passive strategies to bonds because of price and simplicity, in our view the risks of doing so are not justified by the low cost.

THE TOOLKIT



Instead, we believe investors should adjust based on their own fee budgets and appetites for complexity. Making portfolio changes in fixed income does not need to be overly complicated or expensive, and even incremental changes can help to reduce the risks building up in the sector.

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WHAT CAN WE DO?

At the lower complexity/cost end of the spectrum, a multi-sector fixed income fund could potentially act as a one-stop shop solution. Multi-sector funds are active strategies with a broad mandate. Fund managers will have the ability to shift portfolio allocations between countries, currencies, sectors (government, corporate, etc) and securities, allowing their teams to prudently manage funds throughout the economic cycle by adjusting interest rate and credit risk.

Investors with the ability to add moderately to portfolio complexity could take a more focussed approach by appointing specialist active managers targeting different aspects of the fixed income universe. For example, an investor could appoint dedicated credit, duration, and relative value managers as a replacement for their passive bond allocations.

For those with the scope to manage more complex portfolios and with a relatively more aggressive fee budget, a more fulsome strategy of portfolio diversification may be fit for purpose. Investors in this category could consider explicit tail protection strategies, currency programs, commodity allocations, alternative debt and dedicated inflation-linked strategies as part of their broader diversification and income programs. Investors in this camp may also consider changing the mix and style bias of their growth assets to have a more defensive orientation.

Ultimately the path advisers choose should reflect the needs of their clients. Wherever that may be, we hope this paper has served as a call to action for all to reconsider their fixed income investment strategy.