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Research Paper

Fixed Income Complacency

The Practical Side of Fixed Income Today

by Rob Lowry, CFA, Senior Research Analyst

Bradford L. Long, CFA, Partner, Deputy Chief Investment Officer

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Key Observations

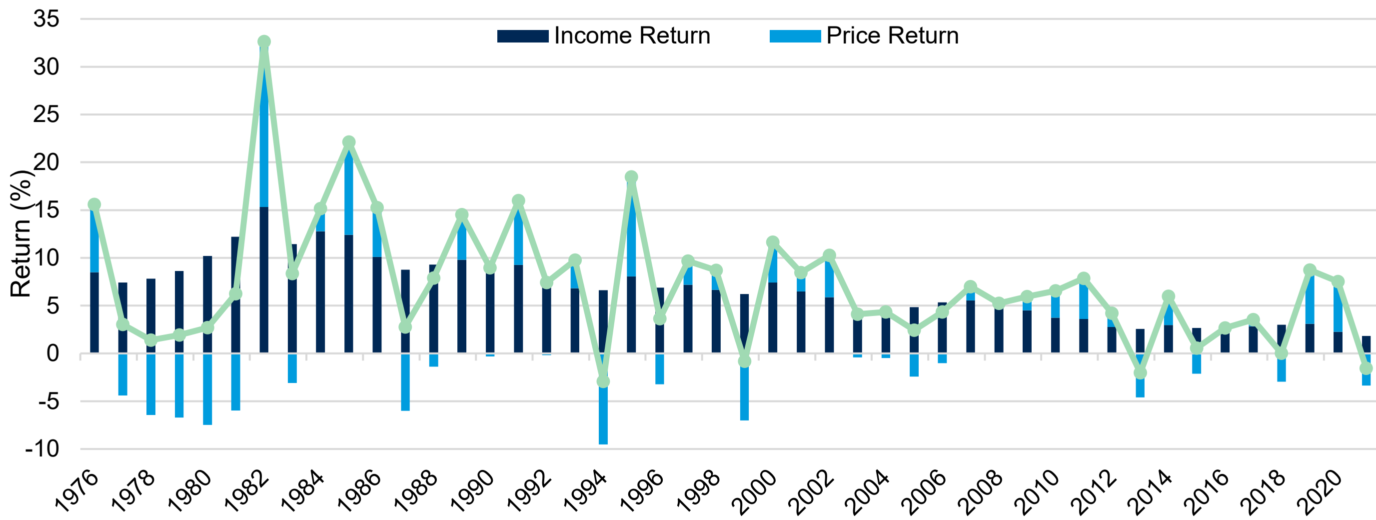
- *Long-term falling interest rates and modest inflation have left many investors complacent about the risks and opportunities within their fixed income portfolios.*
- *We believe investors using history as a guide to how fixed income will weather a rising interest rate cycle may be missing a key difference from the past: punitively low yields.*
- *Fixed income, if sized appropriately, diversified sufficiently and/or used with other asset classes, then investors may be able to achieve favorable results despite these headwinds.*

The last time inflation was seven percent and The Federal Reserve's Fed Funds Rate was rising was 1979. For those keeping track, an investor in current markets who participated in such an environment would be 73 years old, or older, today. While rising interest rates, inflation and changing fixed income markets is not new, it may feel that way. Recent and even long-term history lulled some investors into fixed income complacency. To combat this, we will illuminate how fixed income works, look at where we are today and provide practical strategies for investors to employ in this environment.

Laying the Foundation: How Bonds Work

The primary source of returns from bonds comes from yield (often referred to as the coupon or the income from a bond). This makes the current yield of a fixed income portfolio both important and potentially predicative of future outcomes. The income component of fixed income securities also contributes to mitigating volatility and offsetting periods of time where the price return of bonds may be negative.

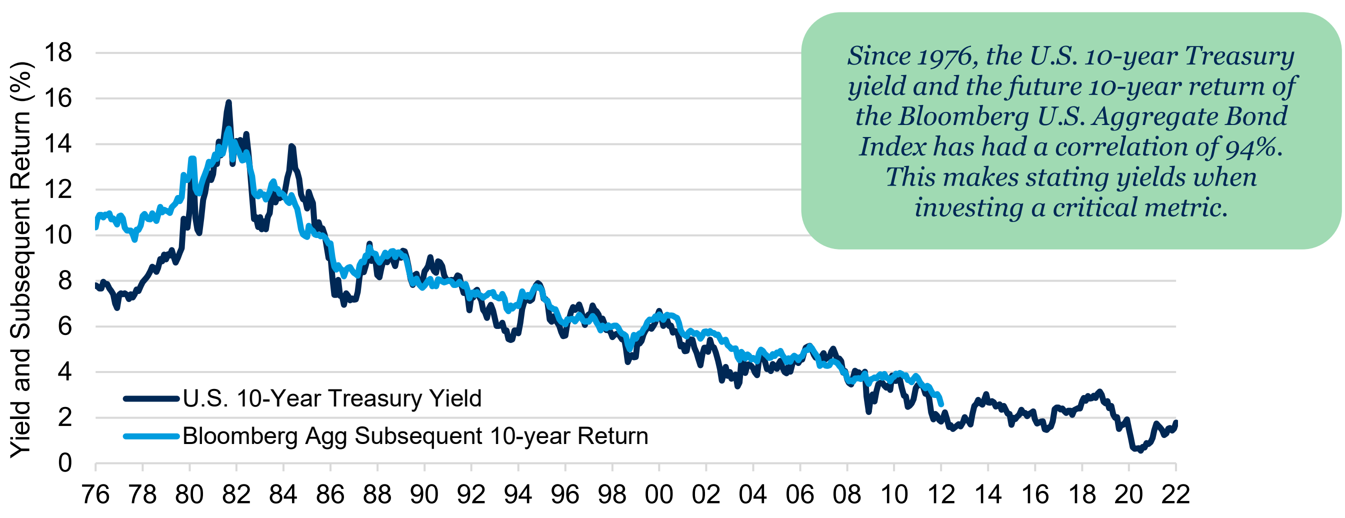
Componets of Return: Price & Income



Source: Fiducient Advisors, Morningstar Direct. Data based on the Bloomberg U.S. Aggregate Price and Total Return Indices. Price return is based on the respective Price Index. Income Return is the difference between the Total Return Index return and the Price Return Index return. Calendar year data from 1976-2021.

A bond's starting yield is a strong indicator of future return. As demonstrated below, we map the 10-year U.S. Treasury yield with the future 10-year return of the Bloomberg U.S. Aggerate Bond Index (the "Index"). There is significant connection between yield and future return. In fact, since 1976, the 10-year U.S. Treasury yield and the future subsequent 10-year return of the Index had a 94 percent correlation.

Treasury Yields and Subsequent Fixed Income Performance



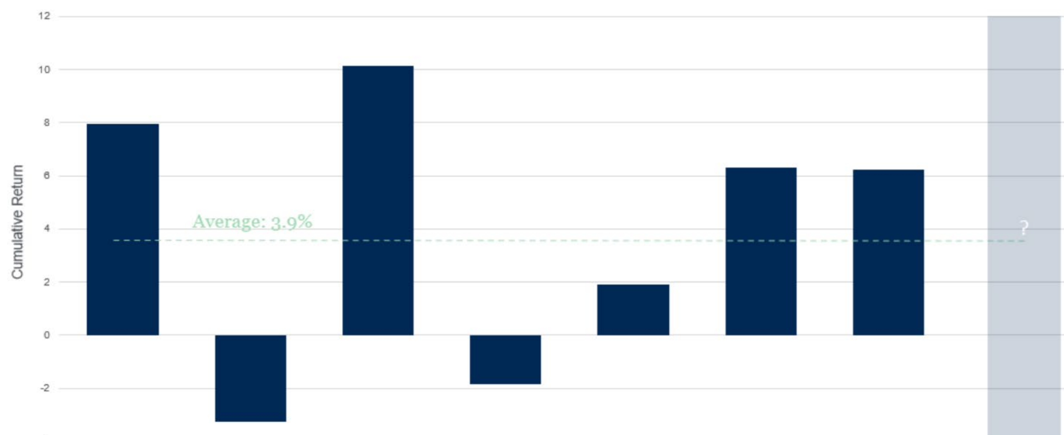
Sources: FactSet, Morningstar Direct, Fiducient Advisors. For the time period January 1, 1976 to January 31, 2022.

Past, Present & Future

This is not the first time we have gone through a rate rising cycle. Since 1983 there have been seven rate rising cycles and as outlined below, markets have reacted differently in past periods. On average, the Index returned 3.9 percent during these rate rising periods. However, let us examine these time periods a bit more before we use this historical analog to quell our concern. As demonstrated above, yield is an important variable to future outcomes. The difference between today and the past is the average starting yield-to-worst was 6.7 percent. This gave fixed income investors a significant head start to positive outcomes.

Bloomberg U.S. Aggregate During Rating Hiking Cycles

On average bonds have weathered previous rate cycles with positive performance. However, previous rate cycles had the benefit of much higher starting yields.

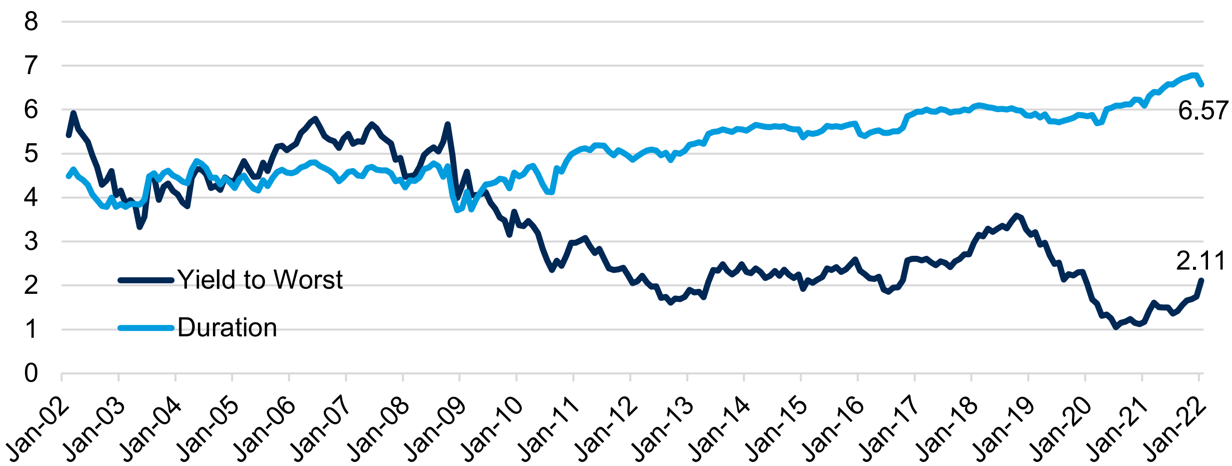


	4/1/83 – 7/31/84	1/1/87 – 9/30/87	4/1/88 – 5/31/89	2/4/94 – 2/1/95	6/30/99 – 5/16/00	6/30/04 – 6/29/06	12/16/15 – 12/20/18	?
Increase in the Federal Funds Rate (%)	3.00	1.44	3.31	3.00	1.75	4.25	2.25	?
Starting Yield-to-Worst (%)	10.88	7.75	8.76	5.62	6.55	4.64	2.59	?

Sources: Capital Group. Bloomberg Index Services Ltd., Morningstar. As of 10/31/21. Daily results for the index are not available prior to 1994. For those earlier periods, returns were calculated from the closest month-end to the day of the first hike through the closest month-end to the day of the final hike. Starting Yield to Worst sourced from FactSet and is taken from the start of the month in the period displayed.

Today, we do not have the same luxury. Yields are materially lower and moreover, the duration of the Index is higher than it has been in recent past. As a result, the Index is more sensitive to interest rate movement than in previous environments yet is offering investors less compensation in return for that risk.

Bloomberg U.S. Aggregate Bond - Yield (%) and Duration (years)

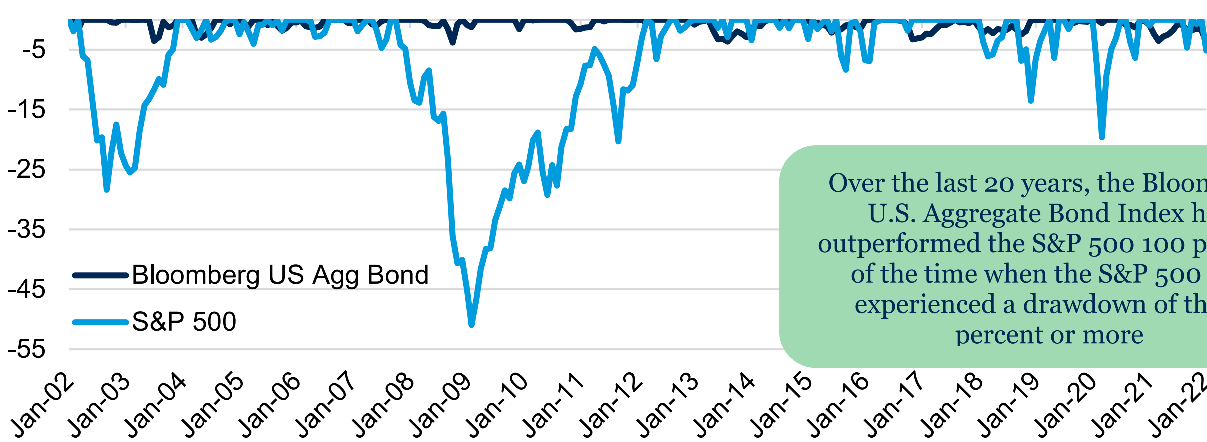


Source: FactSet. Data as of January 31, 2022.

Do bonds still have a place in my portfolio?

Yes! Fixed income has historically been a return generating and risk mitigating asset. Given the current level of interest rates and inflation, positive real returns are likely to be more difficult within fixed income going forward. However, as a risk mitigating asset we believe it can still play an important role in a diversified allocation. Over the last 20 years, the Bloomberg U.S. Aggregate Bond Index has outperformed the S&P 500 100 percent of the time when the S&P 500 experienced a drawdown of three percent or more. Recent notable examples of this capital preservation benefit include the selloff in the spring of 2020 at the onset of the COVID-19 pandemic and the 2008 Global Financial Crisis. Having an allocation to core fixed income during these events helped protect portfolio assets.

Market Drawdowns - Last 20 Years (%)



Over the last 20 years, the Bloomberg U.S. Aggregate Bond Index has outperformed the S&P 500 100 percent of the time when the S&P 500 has experienced a drawdown of three percent or more

Source: Morningstar Direct. As of January 31, 2022.

Use of Indices and Benchmark Return Indices cannot be invested in directly. Index performance is reported gross of fees and expenses and assumes the reinvest dividends and capital gains. Past performance does not indicate future performance and there is a possibility of a loss. See disclosure page for indices representing each asset class.

What now?

We are not proponents of market timing. We believe ardently in using a consistent framework to allocate to the right opportunities in portfolios over the long-term. With some notable headwinds facing fixed income including low current rates, longer duration and inflation – positive real returns within fixed income are likely to be challenged.

With that in mind, we list several approaches to consider. However, the appropriateness of any given strategy will depend on an investor's individual circumstances and the following should not be taken as advice:

1. Diversify a portfolio's fixed income exposure away from traditional core fixed income. Dynamic bond strategies that allocate across the fixed income landscape can help insulate investors from potential rising rate scenarios. These strategies often have lower duration profiles compared to traditional core fixed income and may be able to take advantage of greater volatility in fixed income as a source or return.

2. Marketable alternatives, like hedge funds, if constructed in a risk-conscious way may be a way to seek fixed income-like returns without the reliance on current yields and traditional fixed income nuances. Such an allocation should be considered with broad portfolio objectives and liquidity constraints.

3. All else equal, the best way to avoid potential headwinds in fixed income is to own less of it. Easy to say, perhaps not easy to do. However, investors with a thoughtful approach to risk management, a clear objective and the ability to do so should consider other asset classes that add additional value over the long-term.

For more information, please reach out to any of the professionals at Fiducient Advisors.

About the Authors

As a member of the Global Public Markets Team, Rob researches and performs operational due diligence on core investment managers. He is also a member of our Capital Markets Team. Rob joined Fiduciary Investment Advisors LLC in 2011, which combined with Fiducient Advisors in 2020. Prior to joining the firm, he was an Investment Analyst at USI Advisors, Inc. He received his BA from Bucknell University, is a CFA® charterholder and a member of the CFA Institute and the Hartford CFA Society. Rob volunteers as a member of the Finance and Investment Committee for Chrysalis Center, Inc., a nonprofit organization in Hartford, CT providing support to those struggling with poverty, mental health issues and other challenges. In his free time, Rob enjoys biking with his wife and son, golf, running and platform tennis.

Robert Lowry, CFA
Senior Research Analyst

Brad joined Fiducient Advisors in 2012. He is chair of the firm's Investment Committee and a member of the firm's Discretionary Committee, Research Forum, Capital Markets Team and Mission-Aligned Investing Committee. In 2019, Brad was name named a "Rising Star" in City Wire's annual Professional Buyer publication for his contributions in the investment manager research industry. Prior to joining the firm, Brad worked in various research capacities at Citigroup and Wells Fargo in New York. He received a BA in Finance and Minor in Economics from The University of Colorado and is a CFA® charterholder and member of the CFA Society of Chicago and CFA Institute. Additionally, he is active with Greenhouse Scholars, a nonprofit providing financial and personal support to under resourced college students. In his free time, Brad loves cooking and spending time with his wife and young sons.

Bradford Long, CFA
Partner, Deputy Chief Investment Officer

Comparisons to any indices referenced herein are for illustrative purposes only and are not meant to imply that actual returns or volatility will be similar to the indices. Indices cannot be invested in directly. Unmanaged index returns assume reinvestment of any and all distributions and do not reflect our fees or expenses.

- ***Bloomberg U.S. Aggregate Index*** *covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.*
- ***The S&P 500*** *is a capitalization-weighted index designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.*