TENDENCY TO STABILIZE

The rule that all investing carries risk applies even to bonds. The negative price impact of rising rates over the past few months proves that case well. Even so, bonds in our view remain a fine compliment to equity exposures for those wishing to dampen overall portfolio volatility. To this day bond price swings remain narrower than those we tend to experience for stocks. As that tendency is unlikely to change, we believe bonds will continue to play the role of shock absorber during times of equity market duress.

Declines Aren't Rare

In Figure 1, we chart the relative performance of stocks, versus bonds. Most months, both stocks and bonds gain. This should come as no surprise as both groups tend to see positive performance over longer stretches of time. But the direction of their returns each month often differ, reflecting the potential bonus of diversification. Still, there have been months when both stocks and bonds fell. Seems the possibility for such synchronized declines to occur more often has some investors on edge, in particular with bond yields so low. Given the likelihood rates will continue to rise on account of the improving economy, we might indeed see more months of bond losses ahead. Even so, we continue to expect bonds to bring stability to portfolios, while also offering more appreciable income for the risks they present as rates continue to rise.

Figure 1: Monthly Relative Performance of Stocks and Bonds

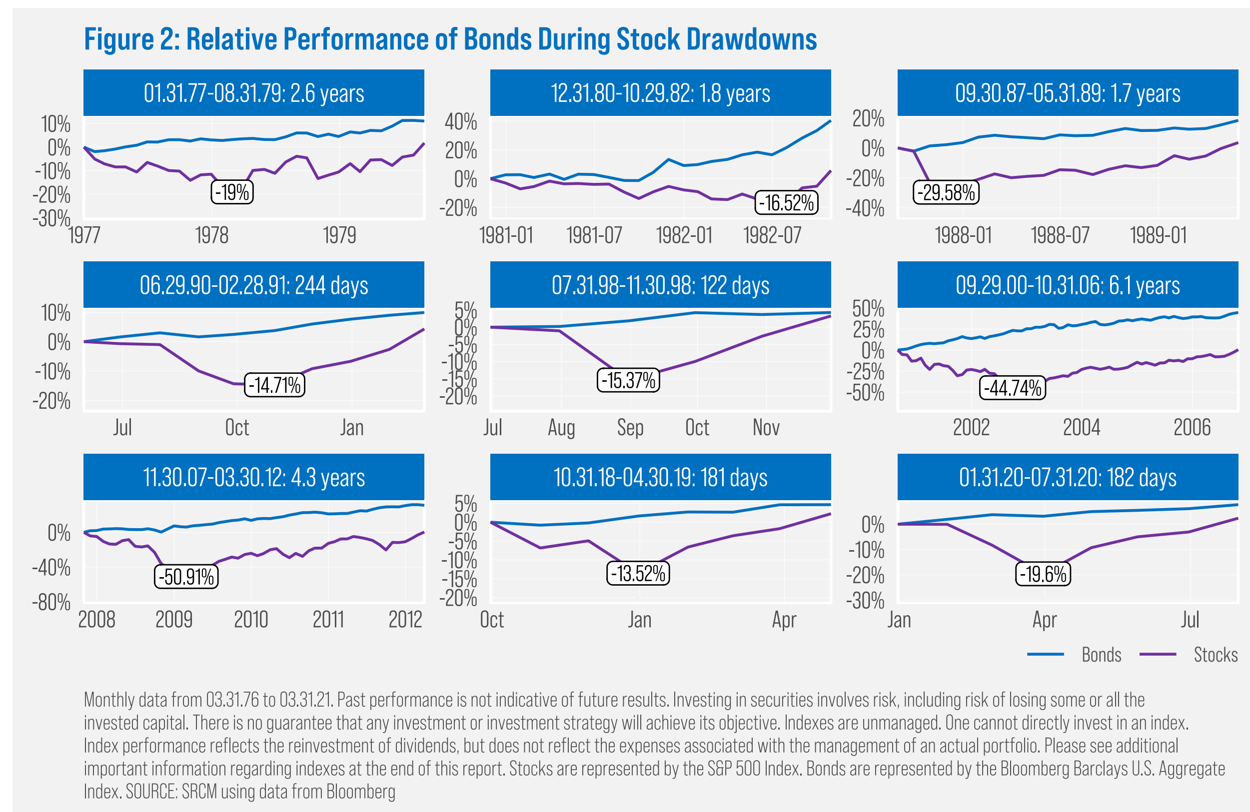
The 251 blue squares represent months in which stocks and bonds both gained. The 115 green squares represent months in which stocks fell, but bonds gained. The 96 orange squares represent months in which stocks gained, but bonds fell. The 78 red squares represent months in which stocks and bonds both fell

From 03.31.76 to 03.31.21. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. Indexes are unmanaged. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. Stocks are represented by the S&P 500 Index. Bonds are represented by the Bloomberg Barclays U.S. Aggregate Index.
SOURCE: SRCM using data from Bloomberg

Relativity Matters

So, it's not particularly rare to see negative bond returns in any month (orange and red squares). Nor is it rare to see stocks and bonds drop at the same time (red squares). But, there's an important distinction between the manners in which stocks and bonds go up and down. Of the 78 months during which both asset classes fell, only 10 of them saw bond prices fall more than those for stocks. And eight of those months occurred during the 1980s, then the result of intensely restrictive monetary policies enacted by the Federal Reserve[1] to combat then rampant inflation.

Zoomed out a bit, the tumultuous early months of that decade look a bit less dramatic. But, that's the story of investing in general, no? The longer the time horizon, generally speaking, the smoother the journey. Smoother is a relative term, of course, as our second chart for the month demonstrates. In Figure 2, using monthly data we display the nine largest drawdowns of the S&P 500 Index, along with returns for the U.S. investment-grade bond market over the same time frame. A drawdown represents a decline from a peak then back to breakeven for the equity index; the data point in the bubble on each individual chart is the maximum decline in the S&P 500 Index over that time frame. Across those nine drawdowns, which include all since early 1976 that saw a decline of 10% or more in the U.S. stock market, we can see that bonds generally served their more commonly intended purpose of relative stability.



[1] An informative assessment is available on the Federal Reserve Web site: https://www.federalreservehistory.org/essays/great-inflation.

Of course, bonds experienced their own drawdowns during each period, but they invariably were lower than that of the equity market. While we do not wish to emphasize that bonds "beat" stocks over these periods—as our focus remains on the relative stability of bonds rather than their relative performance, and stocks generally will have beaten bonds over most reasonably long periods of time—we will note that's true in each case highlighted in Figure 2.

That's not to suggest that bonds do not go through periods of declines as well. The present sustained rise in interest rates since August of last year is yet another example. When we stack up all the historical drawdowns for both asset classes, as we do in Figure 3, we again see a strong distinction between the relative severity of stocks and bonds when it comes to sustained downturns in performance.

Figure 3: Top 10 Drawdowns of Stocks and Bonds

Stocks			Bonds		
Duration	Trough	Drawdown	Duration	Trough	Drawdown
11.30.07–03.30.12	02.27.09	-50.91	08.31.79–05.30.80	02.29.80	-12.74
09.29.00–10.31.06	09.30.02	-44.74	07.31.80–11.30.81	09.30.81	-9.00
09.30.87–05.31.89	11.30.87	-29.58	02.28.94–02.28.95	06.30.94	-5.15
01.31.20–07.31.20	03.31.20	-19.60	03.31.87–12.31.87	09.30.87	-4.90
01.31.77–08.31.79	02.28.78	-19.00	02.29.84–07.31.84	05.31.84	-4.88
12.31.80–10.29.82	07.30.82	-16.52	04.30.08–12.31.08	10.31.08	-3.83
07.31.98–11.30.98	08.31.98	-15.37	12.31.81–03.31.82	12.31.81	-3.74
06.29.90–02.28.91	10.31.90	-14.71	05.31.13–05.30.14	08.30.13	-3.67
10.31.18–04.30.19	12.31.18	-13.52	08.31.20–03.31.21	03.31.21	-3.56
02.29.80–06.30.80	03.31.80	-9.73	06.30.03–01.30.04	07.31.03	-3.55

Monthly total return data from 03.31.1976 through 03.31.2021. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. Drawdown may be measured as the maximum loss from a prior peak value and/or the length of time the portfolio requires to return to breakeven after a prior peak. Indexes are unmanaged. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Bloomberg

Forced to Choose

And that tendency, to us, presents cause to reiterate an important tenet—seemingly becoming more of a distinction—in our approach to the utilization of bonds in portfolios. As the low-rate era seems to have pushed more and more folks to stretch for income, many of the more commonly proposed exposures express increased levels of risk when compared to our favored domain of investment-grade U.S. bonds. Indeed, many of these income-focused exposures may take on characteristics that look more than a bit like stocks exactly when you likely wouldn't want them to. As the tradeoff of that increased expected return is as it always has been—increased risk—these more aggressive exposures tend to lose their ability to serve as portfolio ballast against generally more volatile stocks. That in mind, while we seek to generate as much income as we think defensibly possible in the present ultra-low interest rate environment, we will remain focused on the usage of bonds to dampen overall portfolio volatility.

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The S&P 500 Index measures the performance of the large-cap segment of the U.S. equity market.

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. Components of the index include Treasury, Corporate, Agency and Securitized bonds.

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