

MARKET STRATEGY VIEWPOINT

Know Your Fixed-Income

August 28, 2019

Post-financial-crisis market conditions have made it easy for investors to get complacent about their fixed-income exposure.

In some cases fixed-income portfolios may not be ready to perform “job one”, in our view - act as a buffer against equity risk.

Is your fixed-income portfolio over-allocated to non-core bond segments? If so, your total portfolio may come under undue pressure during periods of sustained market volatility.

Statistically, perfectly positive correlation is +1, and perfectly negative correlation is -1.

Red area highlighted pinpoints high correlations between certain bond segments and equity indices.

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Recent Reminders

The low interest rate environment since the financial crisis has undoubtedly been tough on those investors seeking steady, risk-averse income from fixed income portfolios. Market participants have only rarely seen 3% or higher 10-Year Treasury yields since that time. Meanwhile, U.S. investment-grade corporate bond yields have remained in relatively close proximity to Treasury yields as well. For investors, there have been few “core” bond places to turn for attractive income and modest risk. Prevailing conditions have caused investors to increasingly seek exposures in “non-core” fixed-income sectors, such as foreign markets and bond segments that fall outside of investment-grade. While returns in many of these segments can be attractive, what can often be overlooked is added risk (relative to core bond segments) and high-correlation with equity returns (Table 1). These high-correlations can be problematic during periods of market distress; when investors should look to their fixed-income exposure as a buffer against equity volatility.

Table 1: Cross Asset Correlations: Dec. '07 - Jun. '19

Source: Bloomberg, S&P Dow Jones; Loan Syndications and Trading Association
BBG Barc = Bloomberg Barclays

	BBG Barc U.S. Aggregate	BBG Barc Gbl Treas. Ex U.S.	BBG Barc U.S. High Yld Corp	BBG Barc EM USD	S&P/LSTA U.S. Lvg Loan 100	MSCI All Country World	S&P 500
BBG Barc U.S. Aggregate	1.000						
BBG Barc Gbl Treas. Ex U.S.	0.728	1.000					
BBG Barc U.S. High Yld Corp	0.245	-0.138	1.000				
BBG Barc EM USD	0.582	0.178	0.799	1.000			
S&P/LSTA U.S. Lvg Loan 100	0.014	-0.294	0.903	0.611	1.000		
MSCI All Country World	0.100	-0.185	0.785	0.688	0.677	1.000	
S&P 500	0.033	-0.186	0.717	0.591	0.625	0.960	1.000

During the fourth quarter of last year, in May of this year, and during the month of August, many non-core bond segments offered little respite from the equity volatility. In fact, the traditional, core Bloomberg Barclays U.S. Aggregate Bond Index provided one of the few shields against those

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From December 2007 through June of this year, the S&P 500 Index has exceeded a 1% loss in 38 of the 216 months.

In those “loss” months, the Bloomberg Barclays U.S. Aggregate Bond Index was also down on 15 occasions. In only four of those months did the Agg Index exceed a 1% loss. Two of those four occurred during 2008.

In contrast, the Bloomberg Barclays U.S. High Yield Corporate Index was down in 28 of the S&P 500’s 38 loss months and the HY Index was down by 1% or more 21 of those 28 times.

periods of stock distress. With policy risks more acute, economies stumbling, and limited central bank levers to pull, we believe now is the time to ensure fixed-income portfolios include enough core exposure to help offset a sustained equity drawdown; should one occur. We have been concerned that investors may be relying on too much non-core exposure to fill their bond allocation and thus are ill-prepared for frequent or sustained periods of equity weakness.

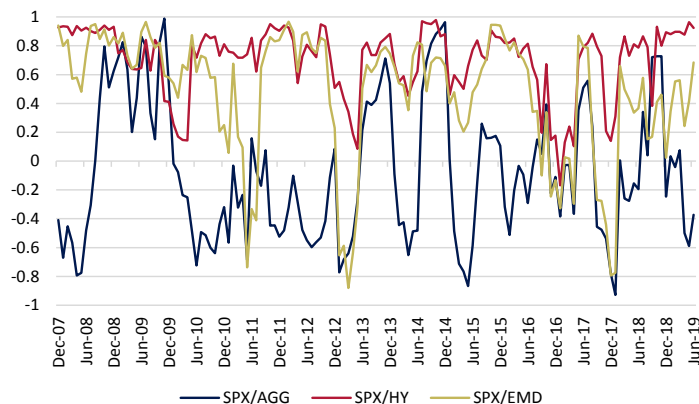
No Free Lunch

The search for income or outsized total return from bonds can typically lead to the non-traditional, multi-sector, global, or high-yield fixed income segments. While we like these segments as compliments to a well-grounded core bond strategy (and adept non-core managers may be able to reduce risk during troubled times) they can fail to meet expectations as the bulk of one’s fixed income allocation. Why? Because these strategies typically involve material credit risk and may include significant currency risk as well. Most notably, their return streams have historically patterned closely with that of the equity asset class. That is, when equities move down, non-core bond segments or strategies may move down as well. The traditional core bond spaces (Treasuries, Investment Grade U.S. Corporates, and U.S. Mortgage-backed Securities), while perhaps boring by comparison, often collectively zig when equities zag....thus offering a potential buffer against equity volatility. So while non-core segments have generally shown attractive returns over the last several years, investors should remember there is no free lunch...what you are paying back for that potential return is the assumption of additional risk.

SPX = S&P 500 Index
AGG = Bloomberg Barclays U.S. Aggregate Bond Index
HY = Bloomberg Barclays U.S. High Yield Corporate Bond Index
EMD = Bloomberg Barclays EM USD Aggregate Bond Index

Figure 1: Rolling 6-Month Correlations: Dec. '07 - Jun. '19

Source: Bloomberg, S&P Dow Jones



Thinking about bucketing fixed-income in core and plus segments may help investors better understand the risks they are taking.

Try a Sound “Core-Plus” Strategy

When building fixed-income portfolios, we generally consider “core-plus” strategies as the way to think about the bond side of the ledger. Core-plus may come in the form of individual bond funds or via personally-assembled bond portfolios. In the core-plus construct, core typically makes up most of an investor’s fixed income allocation...for example, 80% to 100%. This allocation can provide modest returns and act as a buffer against equity risk...a fixed income allocation’s “job-one”, in our view. The plus, or non-core exposure, may be 0% to 20% of your fixed income allocation, depending on market conditions, business cycle placement, and personal risk profile. Percentages of core and plus may also vary depending on unique income need. In general terms, the structure provides an equity volatility dampener while still targeting opportunities for higher returns in other areas of the bond market. We believe this construct can keep the entire portfolio well-grounded and may offer investors fewer correlation surprises. The way we think about it....most often in fixed-income, boring is good.

Table 2: Bond Index/Segment Statistics: Dec. '07 - Jun. '19

Source: Bloomberg, S&P Dow Jones, Loan Syndications and Trading Association
BBG Barc = Bloomberg Barclays

	Period Return	Annualized Return	Annualized Std. Dev.	Yield
BBG Barc U.S. Aggregate	57.2%	3.7%	3.2%	2.2%
BBG Barc Gbl Treas. Ex U.S.	65.8%	4.2%	3.1%	0.6%
BBG Barc U.S. High Yld Corp	133.1%	7.7%	10.4%	5.8%
BBG Barc EM USD	110.2%	6.3%	9.4%	4.9%
S&P/LSTA U.S. Lvg Loan 100	67.2%	5.6%	8.5%	5.0%

Risks

Investors should be aware of the risks associated with all portfolio strategies, and variable market conditions. Monetary policy changes, military activity abroad, the level and change in market interest rates, corporate earnings, domestic and foreign governmental policies, global economic data, and other geopolitical events can have a substantial effect on portfolio performance, our macroeconomic theories, and the effectiveness of strategic and tactical portfolio approaches.

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All opinions and views mentioned in this report constitute our judgments as of the date of writing and are subject to change at any time. We will not advise you as to any change in figures or views found in this report.

Our judgement or recommendations may differ materially from what may be presented in a long-term investment plan. Investors should consult with an investment advisor to determine the appropriate investment strategy and investment vehicle. Investment decisions should be made based on the investor's specific financial needs and objectives, goals, time horizon and risk tolerance.

Stock investing involves risk including loss of principle.

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.

Government bonds and Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

The MSCI All Country World Index is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world.

The S&P 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing the major sectors of the U.S. economy.

The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment grade fixed-rate bond market, including government, government agency, investment-grade corporate, and mortgage-backed securities.

The Bloomberg Barclays Global Treasury ex U.S. Index is an index of foreign government bond market primarily including those of developed markets outside the U.S..

The Bloomberg Barclays U.S. Corporate High-Yield Bond Index is an unmanaged market value weighted index composed of fixed-rate, publicly-issued, non-investment grade debt.

The Bloomberg Barclays EM USD Aggregate Index is benchmark that includes USD-denominated debt from emerging sovereign, quasi-sovereign, and corporate issuers.

The S&P/LSTA U.S. Leverage Loan 100 Index is a benchmark index designed to measure performance of the 100 largest issuers in the U.S. leveraged loan market.

Except for the historical information contained in this report, certain matters are forward-looking statements or projections that are dependent upon risks and uncertainties, including but not limited to such factors and considerations such as general market volatility, global economic risk, geopolitical risk, currency risk and other country-specific factors, fiscal and monetary policy, the level of interest rates, security-specific risks, and historical market segment or sector performance relationships as they relate to the business and economic cycle.

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