LPL RESEARCH

BOND MARKET PERSPECTIVES

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WHY OWN BONDS?

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KEY TAKEAWAYS

Fixed income markets have faced headwinds along with equities recently, an unusual environment historically.

Although rising rates may put pressure on high-quality fixed income, it may remain a critical part of well-balanced, diversified portfolios.

Bonds can provide income, liquidity, and may help smooth out portfolio volatility during periods of equity market stress.

With rising rates making high-quality fixed income more attractive, many fixed income investors may be asking, why own bonds? Despite headwinds from rates, we believe bonds may still play play a vital role as a portfolio diversifier. As corporate earnings move higher and fiscal stimulus provides a further tailwind, the case for stock investing remains compelling, in our view. However, stock market pullbacks can occur without warning, and as mentioned in our *Outlook 2018: Return of the Business Cycle*, we expect more volatility in the coming year, as is typical with an economy in the latter half of the business cycle. Corrections of 10% or more have been infrequent in recent years but such calm is rare, as investors were recently (and unpleasantly) reminded. The average annual peak-to-trough decline in the S&P 500 Index has been 14% over the past 50 years, highlighting the need for investors to be prepared, and high-quality bonds may help provide diversification for portfolios during these types of market events.

REVISITING THE POTENTIAL BENEFITS OF OWNING BONDS

High-quality bonds provide income for investors, but they can also offer liquidity and help to smooth out portfolio volatility during periods of equity market weakness. A look back at prior stock market pullbacks illustrates how bonds have historically provided good diversification benefits. Figure 1 shows all equity market pullbacks of 10% or more over the last 10 years, with the corresponding returns for stocks and high-quality bonds. The figure also illustrates the hypothetical return of a balanced 60/40 (stock/bond) portfolio and the dampening impact bonds can have on stock weakness.

In a few cases, such as our most recent example, both stocks and bonds declined together. This is a rare occurrence historically, but even so, bonds managed to outperform stocks by a wide margin on each occasion. In investing, like other segments of life, our most recent memory serves as our strongest, so the longer-term context is key. In 2008, high-quality bonds provided a buffer but not without volatility, as investment-grade corporate bonds declined for the year and even high-quality mortgage-backed securities suffered brief declines. While not all segments of the bond market perform similarly every time, an allocation to high-quality bonds can potentially be effective at offsetting stock market weakness and may help to limit overall portfolio drawdown.

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NOT ABOUT YIELD

Today's low-yield environment does not negate the potential diversification benefit of bonds. In mid-2015 and early 2016, the S&P 500 pulled back more than 10%. The Bloomberg Barclays U.S. Aggregate Index was flat or positive on both those occasions, despite yields across the Treasury yield curve being meaningfully lower than where they stand today. In fact, during each stock market pullback in Figure 1, bond market performance was fairly consistent, averaging 0.6%, despite varied levels of interest rates.

Over short-term periods, price movement, not interest income, is the primary driver of bond performance. Interest income accrues slowly, and although it is the primary driver of long-term bond returns, price changes (up or down) often overwhelm the impact of interest income over short periods of time. Therefore, we believe a low-yield environment does not preclude bonds from acting as an effective diversification tool.

1 BONDS HAVE HISTORICALLY OUTPERFORMED STOCKS DURING STOCK MARKET PULLBACKS

Pullback Start–End	S&P 500 Index Change	Bloomberg Barclays Index Change	Difference	60/40 Portfolio* Return	60/40 Portfolio vs. All-Equity Portfolio (Difference)
1/26/18–2/8/18	-10.2%	-1.0%	9.2%	-6.5%	+3.7%
11/3/15–2/11/16	-13.3%	1.9%	15.2%	-7.2%	+6.1%
5/21/15–8/25/15	-12.4%	0.0%	12.4%	-7.4%	+5.0%
7/7/11–8/8/11	-17.3%	2.7%	20.0%	-9.3%	+8.0%
5/12/10–6/7/10	-10.3%	1.2%	11.5%	-5.7%	+4.6%
2/9/09–3/9/09	-22.2%	-0.1%	22.1%	-13.4%	+8.8%
1/6/09–1/20/09	-13.9%	0.4%	14.3%	-8.2%	+5.7%
11/13/08–11/20/08	-17.4%	0.4%	17.8%	-10.3%	+7.1%
11/4/08–11/12/08	-15.3%	0.8%	16.1%	-8.8%	+6.5%
10/20/08–10/27/08	-13.9%	-0.1%	13.8%	-8.4%	+5.5%
9/19/08–9/29/08	-11.9%	0.2%	12.1%	-7.0%	+4.9%
8/11/08–9/17/08	-11.4%	2.0%	13.4%	-6.0%	+5.4%
5/19/08–7/15/08	-14.8%	-0.4%	14.4%	-9.1%	+5.7%
Average	**-14.2%**	**0.6%**	**14.8%**	**-8.3%**	**+5.9%**

Source: LPL Research, Bloomberg 02/12/18

Past performance is no guarantee of future results.

*Blended Portfolio: 60% S&P 500 / 40% Bloomberg Barclays Aggregate Bond Index. The 60/40 mix is considered to represent a balanced asset allocation.

Performance shown reflects hypothetical index returns and does not show the performance of an actual investment. Indexes are unmanaged and this model cannot be invested into directly.

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CONCLUSION

Low yields may translate into lower long-term bond returns, and rising interest rates could serve as a further headwind for today's bond investors. However, for investors with shorter horizons or those simply unwilling to endure the entirety of stock market swings, bonds may play a diversification role even in today's low-yield and rising interest rate environment. In conjunction with sectors that historically hold up better against rising rates, such as high-yield bonds and bank loans, an allocation to core bonds may still make sense for suitable investors to provide diversification to help mitigate portfolio risk during potential stock market weakness. ■

Please see our *Outlook 2018: Return of the Business Cycle* publication for additional descriptions and disclosures.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

All market indices discussed are unmanaged and are not illustrative of any particular investment. Indices do not incur management fees, costs and expenses, and cannot be invested into directly. All performance referenced is historical and is no guarantee of future results.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

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

Government bonds and Treasury bills are guaranteed by the U.S. 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. However, the value of fund shares is not guaranteed and will fluctuate.

Bank loan portfolios primarily invest in floating-rate bank loans instead of bonds. In exchange for their credit risk, these loans offer high interest payments that typically float above a common short-term benchmark such as the London interbank offered rate, or Libor.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

Mortgage-backed securities are subject to credit, default, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, market, and interest rate risk.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year, and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

INDEX DESCRIPTIONS

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 all major industries.

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

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