Faith No More: Alternatives to Fixed Income

Investors have historically allocated to fixed income both for yield as well as diversification during equity market declines. However, the historically low yields of today may produce less compelling fixed income returns going forward. Meanwhile, traditional safe haven bonds could prove less safe given elevated bond prices and an uncertain economic landscape of extreme fiscal and monetary policy; as a result, will diversification benefits be less reliable?

BOND YIELDS HAVE DIMINISHED

The utility of fixed income in a portfolio 20 years ago - when the U.S. 10 year yield was around 6% - may be very different from its role today when the yield is approximately 65 bps (see Figure 1). With little yield and less scope perhaps for price appreciation, investors today may hold onto bonds primarily for low-cost protection during crisis periods, rather than for an impactful return.

BOND DIVERSIFICATION IS NOT GUARANTEED

While bonds have often exhibited negative correlation to equities, there is nothing inherent in bonds that make them perform differently than stocks. There have been extended periods when the correlation turns positive (e.g., from the 1960s to 2000 – see Figure 2) and numerous periods of positive correlation between stocks and bonds have surfaced in recent years during key events – including the 2016 U.S. Presidential election and during the COVID-19 crisis in March/April 2020 (see Figure 3).

Whereas during the 2008 Global Financial Crisis the S&P 500 declined more than 55% while the Bloomberg Barclays Global Aggregate Bond Index rose 4%, in contrast, during the 2020 COVID-19 crisis, the S&P declined more than 30% peak-to-trough (February 19, 2020 to March 23, 2020) while bonds fell in price more than 3% during the same time frame.

Figure 1: Downward Trend of U.S. 10yr

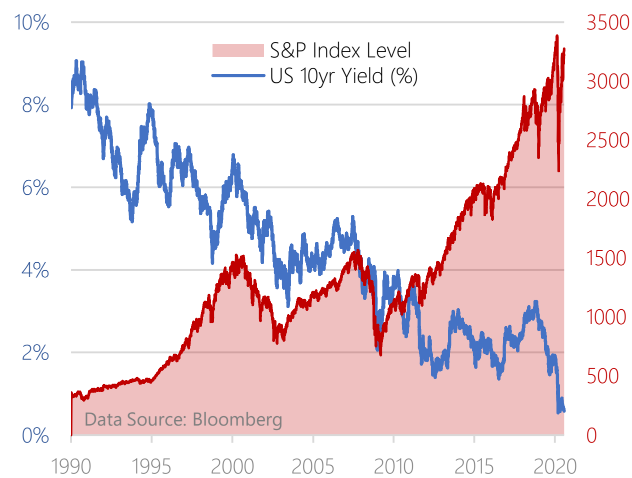


Figure 2:
Long-Term Stock/Bond Correlations

December 1900 to June 2020, 5yr Rolling Window
Based on Data Compiled by the Robert Shiller Database

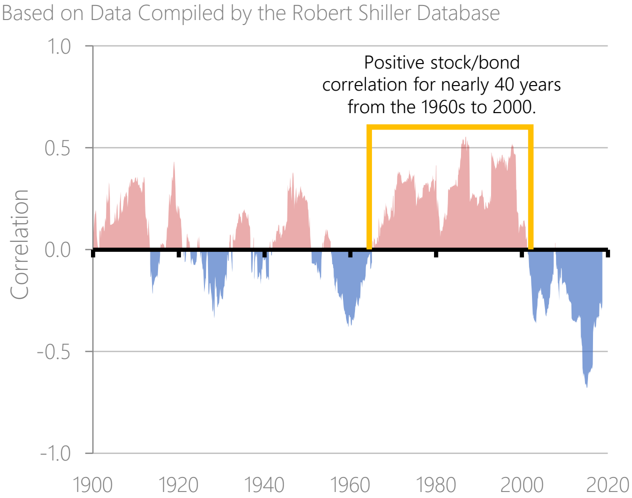
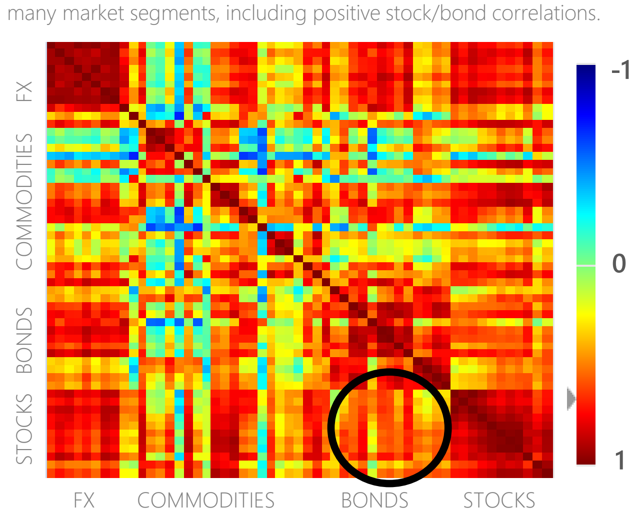


Figure 3: Short-Term Correlations
March/April 2020 COVID Crisis

In March 2020, markets witnessed extreme correlation changes in many market segments, including positive stock/bond correlations.



THE TRADE OFF BETWEEN RETURN AND DIVERSIFICATION

Figure 4 illustrates the long-term and crisis period performance of several investments that are commonly considered safe haven diversifiers. Ultimately, there are trade offs for most of these investments. For example, the VIX hedge provides strong crisis protection, but disappointing returns over the long-term. Safe haven currencies like the Japanese yen and Swiss franc offer neither strong long-term returns nor significant diversification. Meanwhile, by going long and short assets, trend-following and macro strategies have been able to provide similar long-term returns as the S&P but with more diversification than the broader hedge fund index.

Figure 4: Long-Term Annualized Returns vs Crisis Returns[1]

January 2000 through June 2020

[1] Figure 4 represents the average crisis returns and annualized returns for a variety of investments based on monthly performance from January 2000 through June 2020. Crisis periods are defined by the five worst drawdowns for the S&P 500 Total Return Index. Asset classes shown are intended to represent a variety of approaches that may be pursued to achieve diversification to a simple long equity portfolio. Trend, Quantitative Macro, Discretionary Macro, Hedge Fund, and Bond indices are represented by the SG Trend, SG Quantitative Macro, SG Discretionary Macro, HFRI Fund Weighted Composite, and Bloomberg Barclays Global Bond indices, respectively. Please refer to the Index Disclosure at the end of this document.

LOOKING AHEAD

Looking ahead, if fixed income is less capable of delivering both material return and downside protection in a portfolio, it will be important to have allocations to strategies that can. As investors reevaluate the role of fixed income in their portfolios, trend-following and macro strategies are valuable alternatives that can provide meaningful returns and protective, diversifying characteristics during difficult equity environments.

RELATED CONTENT

In Search of Negative Beta

Stock and Bond Correlation

The Winter's Tail – Protecting Against Equity Selloffs

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INDEX DISCLOSURE

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Bloomberg Barclays Global Bond Index: The Bloomberg Barclays Global Aggregate Bond Index is a broad-based market capitalization weighted measure of the global investment grade fixed-rate debt markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. There are four regional aggregate benchmarks that largely comprise the Global Aggregate Index: The US Aggregate, the Pan-European Aggregate, the Asian-Pacific Aggregate and the Canadian Aggregate Indices. The Global Aggregate Index also includes Eurodollar, Euro-Yen, and 144A Index-eligible securities, and debt from five local currency markets not tracked by the regional aggregate benchmarks (CLP, MXN, ZAR, ILS and TRY).

S&P Put Buy: The Cboe S&P 500 PutWrite Index (PUT) is utilized to derive returns for its mirror "Put Buy" strategy to represent a direct hedge against equity market declines. PUT is a benchmark index that measures the performance of a hypothetical portfolio that sells S&P 500 Index (SPX) put options against collateralized cash reserves held in a money market account. The PUT strategy is designed to sell a sequence of one-month, at-the-money, S&P 500 Index puts and invest cash at one- and three-month Treasury Bill rates. The Index is calculated and disseminated daily by the Cboe.

HFRI Fund Weighted Composite Index: The HFRI Fund Weighted Composite Index is an equal-weighted index that includes over 2000 constituent funds which have at least $50M under management or have been actively traded for at least 12 months. There are no fund of funds included in this index. All funds are reported in USD and returns are reported net of all fees on a monthly basis.

SG Discretionary Macro Index: The SG Macro Trading (Discretionary) Index is a subset of the SG Macro Trading Index designed to represent global macro managers who typically employ top-down fundamental research to forecast the effect of global macroeconomic and political events on the valuation of financial instruments. These strategies are discretionary and are frequently focused on a diversified basket of instruments. Managers must meet the following criteria: must trade predominantly a global macro strategy (as determined by SG); and must have Firm AUM greater than $30 million. The SG Macro Index is equally weighted, rebalanced monthly, and reconstituted quarterly.

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S&P 500 Total Return Index: An unmanaged, market value-weighted index measuring the performance of 500 U.S. stocks chosen for market size, liquidity, and industry group representation. Includes the reinvestment of dividends. The S&P 500 index components and their weightings are determined by S&P Dow Jones Indices.

VIX Hedge: Chicago Board Options Exchange Volatility Index (VIX) futures are employed to derive returns for the VIX Hedge strategy, The VIX Hedge calculates the number of VIX futures contracts necessary to return a negative delta of -0.5 to the S&P 500 on a rolling basis. A VIX Hedge is shown based on its ability to provide downside equity protection by virtue of the negative correlation between equity returns and equity volatility. The VIX reflects a market estimate of future volatility, based on the weighted average of the implied volatilities of S&P 500 Index options for a wide range of strikes.

Performance for the **Japanese yen** (JPY), **Swiss franc** (CHF), and **gold** is represented by their respective historical spot prices. These markets have been selected for comparison purposes based on their ability to deliver returns that are historically uncorrelated to equities.

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