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Insights

Bonds: Your boring, but reliable friend...

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"You don't need bonds until you need them."
Anon

Today, investors face some challenging choices when it comes to investing in bonds, but sensible choices can – and must – still be made.

Challenging times

Today, investors face some challenging choices when it comes to investing in bonds, not least because yields are at historical lows and currently below that of UK inflation. As a consequence, too many investors have been tempted to chase higher-yielding bonds, in an attempt to squeeze some return out of what can feel like an unproductive portfolio allocation. This, unfortunately, is an accident waiting to happen – the phrase *'picking up pennies in front of a steamroller'* comes to mind.

Others are asking whether they should be holding cash, as interest rates and thus bond yields are 'inevitably' going to rise, which, as explained later, will dent bond returns, at least in the short-term. This has been a theme, on-and-off, for almost a decade, since the era of low yields began, driven by the Bank of England's quantitative easing programme in response to the Credit Crisis. Those taking the cash deposit route over this period have paid a heavy price, however, losing 15% of their purchasing power compared to just 3% from being invested in short-term government bonds (hedged to GBP)[1]. Second guessing interest rate movements is notoriously difficult (read: close to impossible) and placing deposits instead of owning bonds achieves nothing for the long-term investor, as we shall see.

This paper explores – with the help of timeless insights from **Benjamin Graham**, *'The Father of Value Investing'*, author of the seminal book *'The Intelligent Investor'* and mentor to Warren Buffett – some of the issues facing investors and how sensible choices can be made, which, while seemingly not very exciting, will get the job done when needed.

The challenge, as ever, is to make decisions today that will help to protect and build wealth over time and this, in no small part, is achieved by constructing a framework that can enable investors to remain invested in the equity markets at the worst of times. In turn, this helps to ensure that investors do not systematically destroy their wealth and undermine their financial future, as millions around the world have in the past and inevitably will again.

In this respect, it is critical to remember that the worst of times **will** visit us again over the decades ahead – several times – even if, for some, the very real emotional anguish and attendant poor investment decisions of the last major equity market trauma have faded from memory, or been forgotten altogether.

Benjamin Graham

"Those who do not remember the past are condemned to repeat it."

1 Data: Cash = UK 1 month T-bill adjusted by UK RPI; bonds = Citi WGBI 1-5 Year Hedged GBP from 02/1988 To 02/2018 adjusted by UK RPI. Source: Dimensional Returns 3.0.

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Why own bonds in the first place?

"The more the investor depends on his portfolio and the income therefrom, the more necessary it is for him to guard against the unexpected and the disconcerting in this part of his life."

Alongside an investor's need to achieve a particular long-term return to help deliver both financial security and their desired lifestyle throughout their lives, it is an investor's emotional and financial ability to suffer falls in equity markets – which at times can be stomach-wrenching – that determines how much equity risk they can and should take on. As such, very few investors have the need, or the stomach, for a 100% equity portfolio (it is possible to count on one hand, with digits to spare, the number of Chamberlyns' clients with such a portfolio mix, for example).

The table below summarises the worst five global equity market falls, since January 1970:

Table 1: Worst 5 global equity market crashes

Peak date	Decline (%)	Trough date	Recovery date	Decline (m)	Recovery (m)
Sep-00	-49%	Jan-03	Dec-10	29	95
Jan-73	-40%	Sep-74	Jan-76	21	16
Jan-90	-35%	Sep-90	Jan-93	9	28
Sep-87	-29%	Nov-87	Mar-89	3	16
Jan-70	-19%	Jun-70	Jan-71	6	7

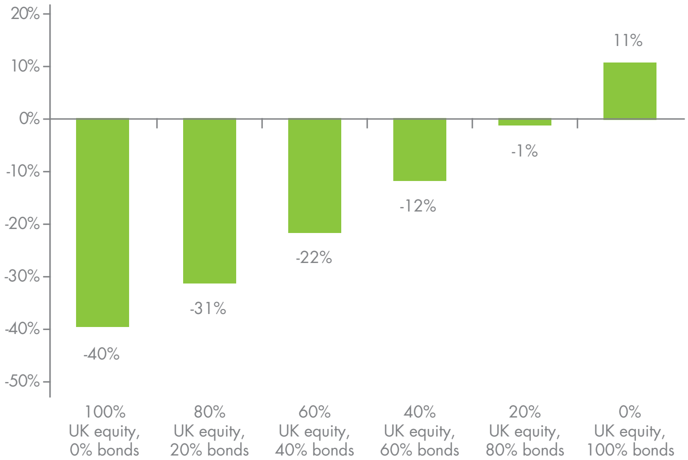
Data: MSCI World Index (net. div.). Source: Morningstar Direct © Copyright. All rights reserved (see endnote).

Investors who cannot emotionally, or financially, afford to suffer these types of falls in value have to take some of this equity risk off the table and own more stable – and thus lower returning – bonds to offset these falls. Think of this as buying an insurance policy against such falls, where the premium paid is the difference between the expected return on equities and bonds, perhaps being somewhere in the region of 4% pa or so, over the longer-term.

When bond returns are very low – and equity markets have been rising – it is easy to forget the old adage that *'you don't need bonds until you need them,'* and wish either that you owned more equities (which might be a reasonable decision / compromise, but certainly needs to be properly thought through), or that your bonds were working harder.

The figure below illustrates the impact of adding high quality bonds to UK equities, for example, during the Credit Crisis. The impact is material and a reminder of the function they are in a portfolio to perform.

Figure 1: Adding bonds helps reduce downside falls – Credit Crisis (Nov-2007 to Feb-2009)



Data: Nominal returns. MSCI UK Index (net), Citi WGBI 1-5 Years (hedged to GBP). No costs of any kind deducted. Rebalanced annually. Source: Morningstar Direct © Copyright. All rights reserved (see endnote).

Very cautious investors may hold material allocations to bonds to avoid large falls in portfolio values and to generate income. For them, inflation is the big, long-term risk (which is the risk that equities help to mitigate, of course). The brutal reality of investing, however, is that no portfolio is ever risk-free: for example, those holding a cash portfolio in place of a simple UK equity and bond portfolio since the Credit Crisis have lost a significant amount of their purchasing power, which can only be clawed back very slowly – if ever – once interest rates are consistently higher than inflation, if and when that eventually occurs.

In this respect, it is instructive to note that a portfolio with 40% equities and 60% high-quality bonds (as per Figure 1 above), fell in value by around 12% in nominal terms during the Credit Crisis, but by the end of April 2018 would have gained 12% in purchasing power terms (43% before inflation), compared with cash still being significantly down in purchasing power terms.

This speaks to a fundamental truth and misconception about investing; the illusion that currency is money. In this view, to fix the number of units of currency one owns is to safeguard one's money, but it is imperative to understand that the only sane long-term definition of money is as **purchasing power**. To incorrectly define the concepts of 'money' and 'safety' in this way is, paradoxically, extremely risky indeed.

"Successful investing is about managing risk, not avoiding it."

A quick recap on how bonds work

In short, bonds are IOUs (i.e. a debt instrument) issued by companies and governments in order to raise capital. They are bought by investors (who are thus acting as lenders), including individuals, bond unit trusts, pension funds and insurance companies, for example. Bonds pay a fixed rate of interest to the investor each year – known as a '*coupon*' – and promise to repay the principal amount borrowed at a specified '*maturity*' date.

The relationship between price and yields

In bond market parlance, the return that an investor expects to receive, on average, per year, over the lifetime of a bond, is known as its yield[2]. At the time the bond is issued, the yield is more-or-less equivalent to the bond's coupon. Thereafter, changes in the yield demanded by investors – to compensate for changes in circumstances / risks – result in changes to a bond's price. This is because the coupon (rate of interest) is fixed throughout the bond's life and therefore, the only element of a bond that can flex to accommodate changing circumstances / risks and investor demands is its price[3].

As such, if yields rise, bond prices fall and conversely, if yields fall, bond prices rise. This is sometimes referred to as the bond see-saw, with yields at one end and prices at the other. The sensitivity of a bond's price to a change in yields is related to its maturity (term) and is measured by its '*duration*', which is defined in years[4]. The further out along the price side of the bond see-saw you are sitting (the longer the duration), the more you go up and down in response to a change in yields at the other end of the see-saw. A useful rule of thumb exists to approximate this relationship between yield and price: *duration x rise (fall) in yield = fall (rise) in capital value.*

Below, one can see clearly that the longer the duration of a bond, or a portfolio of bonds, the greater the change in price for a given movement in yields. This is important to understand. (Note that any fall in capital values will be reduced by the yield on the bond).

Table 2: The longer the duration, the more volatile the price of a bond

	Duration and price change					
Yield Rise	1 Year	2 Years	3 Years	4 Years	5 Years	10 Years
1%	-1%	-2%	-3%	-4%	-5%	-10%
2%	-2%	-4%	-6%	-8%	-10%	-20%
3%	-3%	-6%	-9%	-12%	-15%	-30%

2. Usually this is described as a bond's yield-to-maturity, which takes into account both coupon and capital gains or losses, when the bond is held to maturity.

3. For example: imagine a bond is issued with a one year maturity at a price of 100 (its 'par' value) and a coupon of 4% p.a. If after issue the market demands a 6% yield, the bond's price must fall to 98 to allow the investor to achieve a yield of 6% over the life of the bond. This will be made up of the 4% cash coupon payments made and a 2% capital gain achieved when the bond matures at its par value of 100.

4. Duration is, in effect, the average time in which a bondholder is paid back, when all the cash flows of the bond have been discounted back to a present value.

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Bonds come in all shapes and sizes – picking the right type matters

"The defensive investor will place chief emphasis on the avoidance of serious mistakes or losses."

Bonds vary widely, from very low risk to equity-like in their nature and therefore cannot all be lumped into the 'safe' category, as very often happens. There are two things that define how safe or risky bonds are: to whom you lend and for how long.

Who you lend to matters

If you lend to a company that is less financially sound than another, you would accordingly expect a higher rate of interest. Conveniently, most bonds are assigned a credit rating by a rating agency, such as S&P, Moody's or Fitch, and this provides an indication of how likely a bond issuer is to pay the regular coupons and to return capital to the investor at maturity. Bonds rated from AAA to BBB are known as '*investment grade*' and below BBB as '*high yield*' or '*sub-investment grade*' (they were formerly described as '*junk*' bonds, which might be revealing). The lower the credit quality, the higher the risk that the issuer will fail to meet its interest and capital repayment obligations, but the higher the yield in return. Put another way, there is no free lunch on offer where bonds / debt instruments are concerned; as always, if you want more return, you have to take on more risk.

At times of equity market crisis, money tends to flow from risky assets to high quality, safer assets, driving risky asset prices down (e.g. high yield, low quality bonds) and safer asset prices up (e.g. high quality, AA rated bonds).

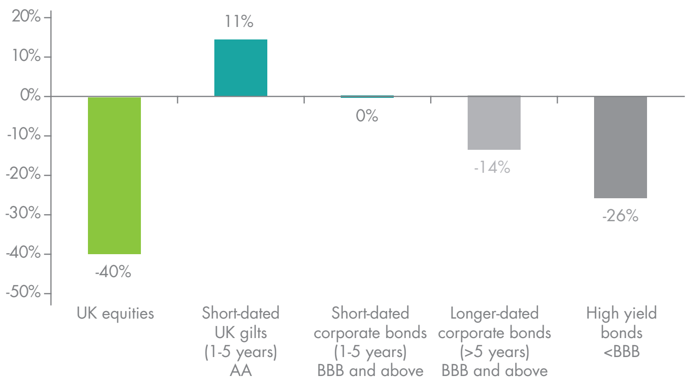
How long you lend for also matters

"The investor should be aware that even though safety of its principal and interest may be unquestioned, a long term bond could vary widely in market price in response to changes in interest rates."

Intuitively, when placing a bank deposit (simply part of the fixed income spectrum), one would expect a higher rate of return, the longer the maturity (term) of the deposit. The same applies to bonds, but the difference is that bond prices become more volatile the longer the term, as explored above.

The credit risk taken and the duration of these bonds really matters, therefore. Looking at the Credit Crisis period again, we can observe the impact of these two choices. Lower credit quality bonds have poorer defensive qualities and those with longer maturities magnify this unfavourable trait. Higher quality, shorter-dated bonds provide a sensible balance between yield and defensive qualities thus. They will never be exciting (they are not supposed to be) and deliver high returns (they are not supposed to; this is what your portfolio's growth assets or 'risk budget' is for), but will perform the role asked of them when equity markets are in turmoil (which they will be, on many occasions, over the decades ahead).

Figure 2: Bond performance during the Credit Crisis (Nov-2007 to Feb-2009)



Data: Nominal returns. MSCI United Kingdom NR GBP; BBgBarc UK Gilt 1-5 TR GBP; Markit iBoxx GBP Corp 1-5 TR; Markit iBoxx GBP Corp TR; BBgBarc Global High Yield TR Hdg GBP. Source: Morningstar Direct © Copyright. All rights reserved (see endnote).

We should be looking forward to yield rises

As the Danish philosopher Soren Kierkegaard noted, "Life can only be understood backwards – but it must be lived forwards."

Today, bond yields sit at historically low levels. Logic, economics and history, however, suggest that investors should demand a return above inflation for lending their money to borrowers. At some point in the future, yields are likely to rise back to such levels. The problem is that no-one knows when, how quickly and with what magnitude it will happen.

Those with a cup-half-empty, short-term view on the world, tend to be fearful of yield rises, due to the falls in capital values that bonds will temporarily suffer ('*temporarily*' is the key word here, as we will explore shortly). Those with a cup-half-full, longer-term view should be looking forward to yield rises, because in the future their bonds will be delivering them with a higher yield, hopefully above the rate of inflation.

★ If you do not have faith in the future, trust in the eternal requirement for humans to have their basic needs and desires met, and belief in the ability of the capital markets and the great companies of the world to capture the exponential power of technological progress and human ingenuity, you should perhaps reconsider owning investments of any description. It is worth reflecting on this for a moment; after all, these are the reasons you ultimately choose to deploy your capital the way you do as an investor and as such, you either have faith, trust and belief in these things or you do not – which is absolutely your choice, of course. If you do believe in these things, then everything else is simply about sensibly managing the journey, the choices you make and the emotional tribulations of being an investor.

★★ Almost every investor will have a life expectancy measured in decades – indeed, more likely multiple decades – and accordingly, as an investor, you should be concerned with sensible exposure to asset classes and their historically and rationally expected behaviours over such a timeframe, rather what may be happening in the news, or on capital markets, this week, this month or in the next two years, for example. Remember, the media is not your friend and bad news sells in a way that good news could only ever dream about and time will prove, as it has proven over and over, that nothing could be less relevant to your financial future and the investment outcomes you experience, than speculation or undue concern about the next *crisis du jour.*

The term '*temporary*' was used in respect of falls in capital values, because that is what they are. When rates rise, bonds earn an investor more than they did before the rate rise and they reach a breakeven point where the new higher yield has fully compensated them for the falls in capital values that occurred when yields rose. The time to breakeven is equivalent to the duration of an investor's bond holdings. Short-dated bonds with a 3 year duration, for example, will break even after 3 years. Below is a hypothetical example:

Table 3: The impact of a 2% rise in yields on a 3 year duration bond portfolio

Year end	Today	Year 1	Year 2	Year 3	Year 4	Year 5
Yield-to-maturity	1.5%	3.5%	3.5%	3.5%	3.5%	3.5%
Immediate yield rise %	**2.0%**	-	-	-	-	-
Capital loss*		-6.0%	0.0%	0.0%	0.0%	0.0%
Yield during year		3.5%	3.5%	3.5%	3.5%	3.5%
Total return for the year		-2.5%	3.5%	3.5%	3.5%	3.5%
Cumulative total return		-2.5%	0.9%	4.4%	8.1%	11.9%
Annualised total return		-2.5%	0.5%	**1.5%**	2.0%	2.3%

Note: * We have assumed that the capital loss is approximated by the rise in yield, times the duration. In reality, due to convexity, capital losses would not be quite so great.

Holding cash deposits is not the solution

"Abnormally good or abnormally bad conditions do not last forever."

Imagine that an investor felt that rate rises were likely to occur, with a detrimental – albeit temporary – impact on bond returns in the near future. They decide to place a deposit for 3 years, receiving interest of 1.5% pa, comparable to the current yield on 3 year bonds.

Let's assume that they are right and bond yields do rise shortly thereafter – as in the table above – and bonds suffer an initial fall in price. Although they may feel pleased at first, the reality is that in 3 years' time when their deposit matures, they end up with the same return as the bond portfolio. Yes, it's true, as you can see from the green-coloured cell in the table above.

Others may be tempted to place the funds in an easy access account and try to time when to get back into the market. However, easy access accounts will pay lower rates than 3 year deposits and what happens if yields do not rise? The answer is that returns on cash will be lower than the return of 1.5% p.a. in the bond portfolio. Timing markets is not an easy game to play and should be avoided (it is as impossible as timing interest rate or stock price movements and leads inexorably to wealth destruction).

"In the financial markets, hindsight is forever 20/20, but foresight is legally blind. And thus, for most investors, market timing is a practical and emotional impossibility."

A quick thought on considering trying to arbitrage your adviser's fees

Related to the above point: it might be tempting to think that if there may, for a time, be little difference in returns between bonds and cash in the event of a yield rise, then withdrawing some of the money held in the bond element of your portfolio and placing it into cash will mean that you can avoid paying your adviser's fee in respect of that part of the portfolio for a while.

However, assuming you work with a high-calibre financial planning firm, this is to overlook the true value of the ongoing planning, advice and service that you receive, which will include, for example:

- building and overseeing your comprehensive, evolving wealth plan and the life goals it contains;
- supporting and guiding you through both material events in your life journey and bad times in the capital markets;
- undertaking often highly complex and valuable tax planning;
- handling the intricacies of pension / retirement / financial independence planning over several years before, during and long after your full-time work or business activities have ceased;
- managing your exposure to critically important 'sequencing risk' in the capital distribution / enjoyment phase of your life;
- always being up to speed on your personal situation and thus able to help you and your family at very short notice;
- saving you an incalculable amount of time;
- helping you to avoid extremely costly or even life-changing mistakes;
- providing you with clarity, confidence, comfort and peace of mind;
- Etc.

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Taking a fee from your portfolio is simply a hassle-free means of paying for the planning, advice and service that you receive, and a decent planning firm should, in any case, be worth multiples of the marginal cost of working with them over time.

As such, examining the overall relationship fee against a specific element of your portfolio (today, it might be bonds, but in 5 years' time it might be global smaller companies, or global commercial property, or emerging markets etc.); unfairly penalising your adviser for a 'problem' which is neither of their making nor directly within their power to 'fix' (it can only be managed); leaving yourself with a portfolio that is almost certainly not ideally aligned with your long-term wealth plan and potentially jeopardising an otherwise good and enjoyable relationship (which will be much more valuable to you over the long-term than the small, short-term savings you might make by tinkering with your bond holdings) is to completely miss the wood for the trees.

"…The role of the adviser… is to protect his clients against mistakes and to make sure that they obtain the results to which their money is entitled."

Conclusion

Bonds are a very important element of most portfolios, providing lower absolute levels of volatility than equities and protecting portfolios from the periods of severe equity market trauma that occur periodically. As bond yields and prices are inversely related and prices move more when bonds have a longer duration, owning shorter-dated bonds reduces the time to breakeven from a rise in yields – indeed, long-term investors should be looking forward to rises in yields, as they will be better off in the coming years.

Placing a deposit to avoid yield rises does not help and is of little practical merit for long-term investors. Owning higher quality bonds over lower quality bonds makes sense too, as they provide a better likely outcome, just when you need them to.

Your bonds might be boring for extended periods of time, but that is much better than them being dangerous, and while you need to be prepared for unexciting returns for a while as yields – potentially – move back to a more normal level, it is impossible to know when or how quickly this will happen. Therefore, don't try to second guess the guessers; just relax and remember: *'you don't need bonds until you need them'.*

Best regards

Michael

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Michael Smith *CEO*

In addition to being a Chartered Wealth Manager, Michael is a Chartered Financial Planner and holds the globally recognised Certified Financial Planner qualification. He is also a Fellow of both the Personal Finance Society and the Chartered Institute for Securities & Investment and as such, is one of the most highly qualified financial planning professionals in the UK. Michael also sits on Chamberlyns' Investment Committee and helps to produce the firm's regular series of in-depth 'Insights' articles, which explore, explain and demystify often complex wealth planning issues.

Chamberlyns provides a refreshingly different Wealth Management service for executives, senior professionals and business owners, who want to make the most of their money and the life that lies ahead of them.

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