



Confidence in Your Investments: Retirement Plans, Financial Planning & Wealth Management

Understanding “Bond Math”

“People worry about the riskiness of stocks, but bonds can be just as risky.”

Peter Lynch

“While we can learn from the long run about how bonds and stocks respond to changing environments and to each other, the long run can tell us perilously little about what kinds of environments lie ahead.”

Peter Bernstein

As these giants of investing shared decades ago, bonds are far from riskless investments. Allow us the leniency of beginning with a chart:

Negative Return Years for Bonds Since 1976

Bloomberg Aggregate Bond Index (AGG)	
1994	-2.92%
1999	-0.82%
2013	-2.02%
2021	-1.50%
2022	-13.00%
2023*	-1.20%

* Returns from Bloomberg. 2023 shown through 9/30/23.

Suffice it to say, many investors are struggling to understand the returns experienced by their bond portfolios over the most recent three years. Not only are we approaching a 3-year losing streak in bonds that has never transpired since the formation of this country, but the scale of losses has caused meaningful damage for some investors.

Paraphrasing Bernstein, the past is the past and we are only as wise as what we gleaned from it. We should not use it blindly to predict the future. What can we learn from the past and how has our team managed through this challenging time? What do we see on the horizon? ***What’s the math today for bonds?***

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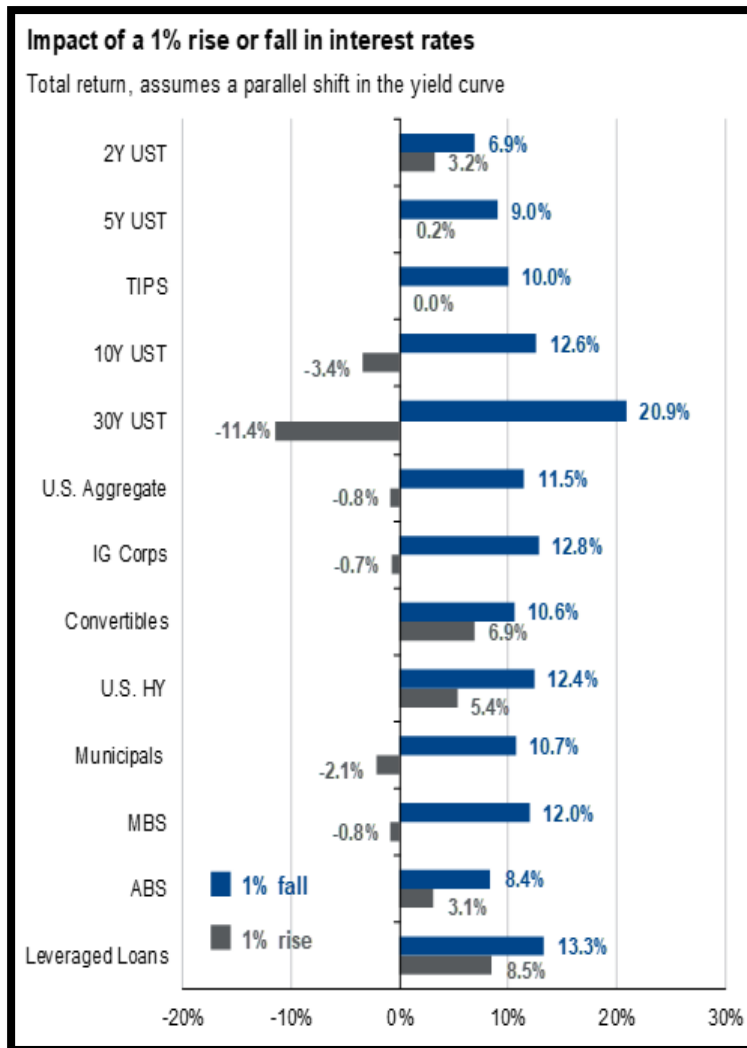


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Many of us have heard the adage that stocks price on hope and that bonds are simply math. While anecdotally partially true, to what math are these people referring. In the industry, we call it [creatively] “bond math.”

For today’s study, we are going to focus exclusively on bonds whose price moves as a function of interest rates (and not creditworthiness). We will discuss credit-sensitive bonds some other time.

The critical calculation for understanding what to expect out of a bond is its duration. Duration is simply an expression of how a bond is anticipated to move as a function of prevailing interest rates. The chart below from Bloomberg & Factset illustrates how a relatively modest move in interest rates effects different types of bonds.



How has HIP posted 5 - 6% outperformance vs. the AGG YTD for our clients?

For 2023, the key for us has been owning “spread” and low duration. Spread refers to credit-sensitive bonds like high yield and leveraged loans. Low duration refers to owning bonds whose rate sensitivity was low (like that of the 2Y UST at left).

Will that work from here?

The risk we now face is reinvestment risk-- the risk rates are meaningfully lower when it’s time to redeploy capital. Our approach over the last few weeks (and likely into 2024) has been to increase exposure to IG credit (high quality) while adding duration to portfolios. We still believe it’s early to extend duration to that of the AGG but acknowledge that the opportunity in front of us for total return is exciting.

One Last example:

Consider the portfolio with a 4 yr duration and a 6% distribution yield. Over the next 2 years, a 2% drop for rates could produce a return of 20% cumulative (2 x 6% coupons + 2% x 4 duration). ***In our minds, such a bond return could outpace many equity strategies as we enter a slowing economic environment and an election year!***

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