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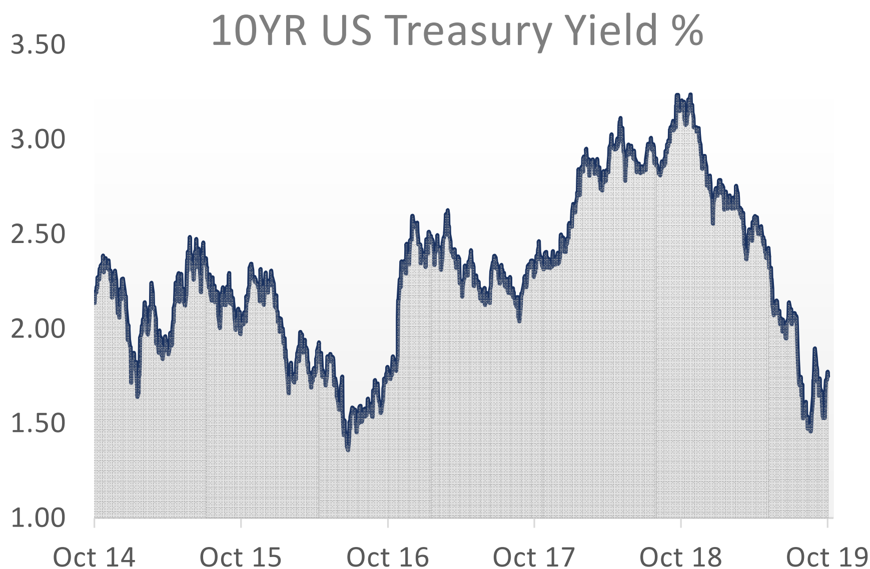
It's Not Just About the Yield

While the United States has not yet faced the same structural issues that have driven interest rates in many developed nations below 0%, investors here at home must contend with lower yield levels than in the past.

Given this current interest rate environment, some have asked why it makes sense to continue investing in bonds.

The answer to this question lies not only in how a bond's structure differs from other investments, but also how they interact with other asset classes when used to construct and meet the objectives of a client's asset allocation strategy.



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The Role of Fixed Income - A bond's structure is its greatest attribute, and by that we mean the certainty it helps provide an investor. Bonds, assuming they do not face a credit impairment, will mature and will pay a regular amount of cash flow over its life. This predictability in a world that is increasingly uncertain is what continues to make fixed income a dynamic and essential asset class across all market cycles.

- Bonds offer income and less volatile returns that act as risk buffers so clients can take on risk (in equities, for example) where it is more appropriate
- Offer a source of liquidity for unforeseen events
- Generate consistent, easily forecasted cash flows
- Help protect capital across various market cycles

For example, let's just look back to December 2018 when the S&P 500 dropped nearly 15% in less than a month. During this same period, an investor who owned a 10YR U.S. Treasury bond would have experienced a 3% return, and it was not yield that helped this investor. In fact, the yield component of that 3% return would have been only about 0.20%. It was the demand for a safe haven asset during a period of uncertainty and heightened risk market volatility that drove up prices on high quality bonds. This counterbalance between lower risk (bonds) and higher risk (equity) investments is what makes fixed-income, even at lower yields, such an import part of a well-diversified portfolio.

Cash vs. Bonds – One might say, "Why wouldn't I just go into cash at these yield levels?" Cash in today's environment does have appeal as an ultra-low risk income source, but cash simply cannot replace what core fixed income holdings offer for the overall asset allocation. First and foremost, cash will not provide any meaningful positive return offset during times of market stress as mentioned above. Also, cash is a floating rate vehicle and provides no predictability of future yield or income levels. Granted, interest rates on cash deposits and money market funds have been attractive of late given previous rate increases by the Federal Reserve. However, it is likely those money market yields will track lower as the Fed has been cutting rates in an attempt to keep the current economic expansion alive. It is important to remember that a well-managed fixed income strategy that deploys capital across a longer horizon can help investors maintain a more stable income stream over extended periods, even as interest rates fluctuate.

What if Rates Actually Rise – A significant increase in interest rates is certainly not our base case scenario for the near- to medium-term, but it is one that must be carefully considered, particularly when yields are low. To help combat the effects of interest rates moves, Caprin's Intermediate Municipal Strategies are strategically positioned from a duration and maturity standpoint seeking to minimize the impact of rate increases. Our experience and expertise in building core bond portfolios helps ensure clients have sound cash flow from both coupon income and future maturities that can be reinvested to capture improving yield levels, should that be the case.

Conclusion - Bond investors everywhere would like higher yield levels than currently available in the market, but it is important to not simply chase income by moving into or significantly increasing exposure to riskier assets. Bonds continue to be an essential part of a successful long-term investment strategy because of the comfort provided by a known income stream, defined maturity dates, and because their lower volatility profile provides a counterbalance to returns produced by riskier asset classes.