The Continuing Fat Pitch: Non-Traditional Bonds

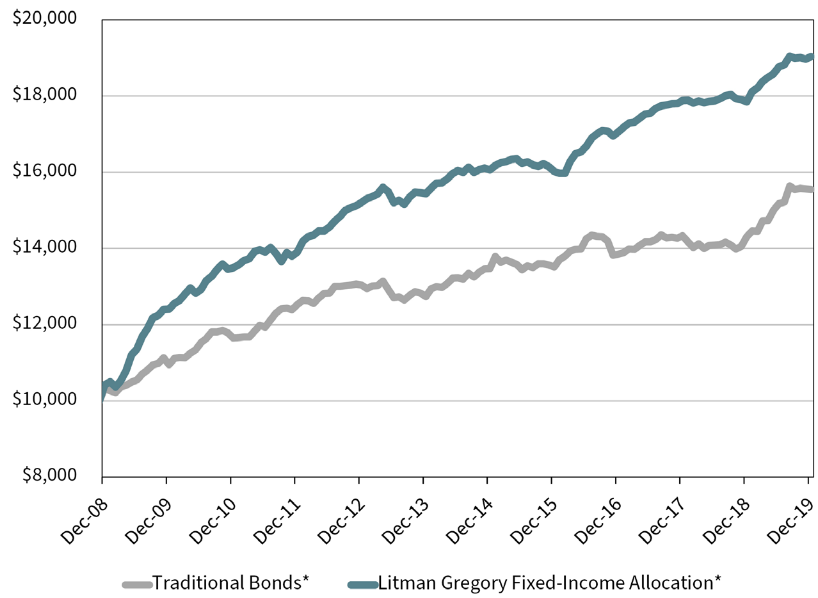
While we like the protection that traditional investment-grade bonds provide, their yields have been paltry for years. Our return expectations for the asset class have been in the low single digits under a wide range of economic and interest rate scenarios. Our analysis also indicated that if interest rates were to rise sharply, traditional bonds would be susceptible to potentially large short-term downside, which many investors are not prepared for. So in the years following the financial crisis, we moved a significant portion of our fixed-income exposure into flexible income strategies run by active managers and then later added an allocation to floating-rate loans:

- The flexible income strategies we selected are distinctive, actively managed strategies with a history of success, run by experienced portfolio managers. Generally, they have unconstrained mandates and possess the flexibility to take on higher credit risk, invest in floating-rate versus fixed-rate securities, or even hold cash if opportunities are scarce.

- The actively managed floating-rate loan funds we own should generate returns that are comparable to the passive leveraged loan options over a full credit cycle, despite being more conservatively positioned. Floating-rate loans are attractive to us because of their higher yields compared to traditional bonds and their structural advantages over high-yield bonds: Their seniority in the capital structure leads to lower defaults and higher recovery rates, and their coupons adjust upward with rising rates, resulting in next-to-no interest rate risk.

The motivation behind this move away from traditional bonds was to lower our exposure to rising interest rates, while also increasing returns in most plausible scenarios. The tradeoff is that we took on increased credit risk. But by combining traditional bond funds with more credit-oriented strategies—each exposed to a different *uncorrelated* primary risk—we believe we built a superior fixed-income allocation. Our positive view of the prospective performance of our bond portfolios is reinforced by the fact that they have an overall higher yield *and* lower duration than our benchmark (the Vanguard Total Bond Market Index).

Our Fixed-Income Allocation Has Strongly Outperformed



*Source: Litman Gregory Analytics, Morningstar Direct. Data 12/1/08 through 12/31/19. * Litman Gregory Fixed-Income Allocation is a proxy of the active bond allocation Litman Gregory AdvisorIntelligence recommended over this period. Traditional Bonds is the Vanguard Total Bond Market Index (VBMFX).*

Let’s look at the results. Since we initiated our move away from traditional bonds in December 2008, our fixed-income portfolios have far and away outperformed the traditional bond market index fund, with nearly identical volatility.

Clearly, “safer” traditional bonds are not without risk, they are simply exposed to a *different* risk—interest rate risk. At the start of 2016, credit-oriented bonds fell along with equity indexes, but the impact on our portfolios was muted. Later in the fall of that year, traditional bonds suffered a drawdown of their own on expectations of a pro-growth Trump presidency (and higher rates), during which our non-traditional bond holdings performed well. In 2018, we saw periods when both stocks *and* bonds declined at the same time. Then stocks experienced one of their worst fourth quarters in history. Despite higher credit exposure, our fixed-income allocation still effectively matched the core bond index for the year.

2019 Update: Given the strong appreciation in investment-grade corporate bonds, in August 2019 we swapped some of our exposure there for a modest position in intermediate-term Treasuries. However, we are maintaining our higher credit exposure. Treasuries should enhance the diversification in our overall allocation by better protecting the portfolio against negative events (relative to diversified core bond holdings).

	Annualized Return	Cumulative Return	Standard Deviation	Max Drawdown	Upside/ Downside Capture	Sharpe Ratio	Equity Correlation	Equity Beta
Litman Gregory Fixed-Income Allocation*	5.98%	90.36%	3.10%	-2.85%	95.68%/ 12.43%	1.70	0.52	0.12
Traditional Bonds*	4.06%	55.45%	3.13%	-3.76%	-	1.11	-0.09	-0.02

*Source: Litman Gregory Analytics, Morningstar Direct. Data 12/1/08 through 12/31/19. *Litman Gregory Fixed-Income Allocation is a proxy of our active Balanced fixed-income allocation over this period. Fund holdings and performance varied depending on platform availability and client circumstance. Traditional Bonds is the Vanguard Total Bond Market Index (VBMFX). Standard deviation is annualized. Max drawdown is based on monthly returns.*

From the table of metrics above, one can see from the positive equity correlation that we’ve been willing to accept some additional credit risk in exchange for higher long-term returns and less interest rate sensitivity. Still, the equity beta of our bond portfolios in this market cycle has only been about 0.12, implying that if relationships hold, their downside during equity selloffs should be a fraction of what stocks experience. In addition, we have high conviction in our active managers’ bottom-up security selection. We continue to believe the added credit risk of our non-traditional holdings is more than offset by the protection they provide against the prospect of rising interest rates. It’s telling that despite the higher credit risk, our bond allocation has captured almost all of the core bond fund’s upside, while avoiding the vast majority of the downside.

We want to specifically highlight the maximum drawdown of our bond allocation over this time, because we believe that metric approximates how many investors “experience” risk. This market cycle has encompassed dislocations related to rising rates and to declines in risk assets—our portfolios held up well through each. The max drawdown of our bond allocation was much lower than the benchmark’s, despite the higher equity correlation and beta. This lower drawdown was not surprising to us; it was the intentional goal of our portfolio construction. Our exposure to non-traditional bonds protected the portfolio against declines in traditional bonds, and vice versa, leading to a superior Sharpe ratio, a common measure of risk-adjusted return.

The insight and conviction to execute these portfolio decisions derived from the intersection of Litman Gregory’s asset class analysis and manager research capabilities. Our work on expected returns—both long-term returns and 12-month downside—and the various stress tests we run identified the risk of rising rates, while our due diligence experience in selecting successful managers allowed us to take advantage of the opportunity presented by more flexible strategies and floating-rate loans.

—Eric Russell Figueroa, CFP®, and Jack Chee

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