HAS YOUR FIXED INCOME ALLOCATION GONE ON VACATION? NOW IS NOT THE TIME TO ABANDON BONDS

Yield is destiny.

At least in the fixed income market, it is. The math behind the yield of a fixed rate bond is immutable and rather simple. An investor gets the promise of a fixed future income stream from a borrower willing to pay interest to use the money (principal) right now. In annual percentage terms, that amount of interest is expressed as "yield," and unless the bond issuer defaults on its promise, that's what the investor's return will be through the final maturity of the bond.

While an investor can choose to close his or her eyes until maturity and just be satisfied with the income generated from a particular bond, the global bond market's eyes never close. The bond market will look to trade that bond, and how a bond's price changes is probably among the least understood concepts in finance. Simply put, bond yields and bond prices move in opposite directions. More precisely, when prevailing interest rates decline, the market prices of outstanding bonds increase. Conversely, when prevailing interest rates increase, the market prices of outstanding bonds decline.

No matter how often this curious bond equation is covered in the financial press, it seemingly must be relearned. The two countervailing forces at play – shifting interest rates and the prices of bonds in a portfolio – serve to smooth out returns in a broadly diversified investment portfolio. In addition to generating income, bond portfolios and bond mutual funds serve as effective "shock absorbers" against volatility in other markets, especially the stock market. In periods of turmoil or recession, interest rates typically fall, resulting in price gains in your bonds that help offset losses that may be incurred in your stocks. Conversely, if stocks are zooming because of a strong economy, interest rates will typically rise and knock down bond prices, dampening some of the outsized returns from your stocks.

But for much of this year, the zig-zagging of bond prices and stock prices has been out of sync, as both markets tended to react negatively when expectations grew for the Federal Reserve (Fed) to hike rates further or faster. The bond portfolio or bond fund you thought would promote stability and act as a counterweight to stock volatility has gone on vacation. Bonds have been beaten up lately, even as some unsettling stock market volatility appeared for the first time in about two years. Returns are down across all major investment-grade bond sectors so far this year. The overall U.S. bond market, as measured by the Bloomberg Barclays Aggregate Bond Index, is down about 2%.

But like any vacation, this one can't last forever. The broad bond market has had a negative annual return only three times between 1990 and 2017. Clearly, 2018 is off to a rough start for bondholders, but investors who are content with their long-term investment goals should ride this out.

Here's why: Higher yields serve as a powerful tailwind for future returns in bonds. By maintaining exposure to bonds as interest rates rise, the reinvestment of all maturities and coupons compounds at those higher rates, offsetting the current decline in bond prices. The key words are over time.

While it is a challenge to adhere to this course as we enter the latter stages of a maturing economic expansion, remember that the Fed's rate hikes have their most influence on yields of the shortest bond maturities. 30-day and 90-

day Treasury bills move almost in lockstep with the Fed's overnight rate setting, but as you move out the "yield curve" to longer maturities (especially 10 years out and beyond), the Fed's moves carry less weight. In fact, while the Fed has raised overnight rates by 1.75% since its first hike on 12/15/2015, the yield on the 30-year Treasury bond over that time has barely budged, hovering near 3%. Maintaining a well-diversified portfolio of bonds across the entire yield curve (or owning a bond fund that does the same thing) takes advantage of the full spectrum of market rates.

Furthermore, the Fed's current campaign of rate hikes is finite – within 18 months it could be over for a while, and maybe even reverse. By staying the course and not getting out, bond investors could enjoy the flipside of the bond price/rate equation – seeing their bond prices increase as interest rates decrease.

Finally, and perhaps less appreciated, is the fact that bonds can behave somewhat like stocks in terms of their ability to confound market timers. For instance, if you had missed out on just the ten best days of percentage gains in the stock market over the last decade, your total return would be greatly reduced. The average annual return for the S&P 500 Index over the last 10 years (2008-2017) was a gain of 8.5%, but miss the ten best days of the decade by not being in the market, and that gain drops to a paltry annual return of 1.3%. Interest rates also have short bursts of big moves, and being whipsawed in the fixed income market is not conducive to good portfolio management. Rates are notoriously hard to predict, and it's better to remain invested over the long term. Moreover, by the time the next worldwide economic shock comes around, rates may have already fallen, and it will be too late to take advantage of juicy yields that are no longer there.

Just remember, the purpose of bonds in a portfolio is primarily to earn income and provide an investor with a potent diversifier against big stock market fluctuations, a normal part of any market cycle. Performance of a bond portfolio or bond fund is best measured over a period of years, not a period of months.

Which brings us back to our original thought, that yield is destiny. If an investor purchases a 10-year Treasury bond, which yields about 3% right now, he or she will earn about 3% over the next 10 years. The math is inescapable over time. That 3% looks pretty competitive when the average S&P 500 dividend yield is about 2%, especially if stock prices come under pressure or continue to experience volatility.

Ironically, bond investors should be rooting for higher rates rather than fearing them. This is why we do not encourage investors to abandon the bond market or to move materially short in maturity with their fixed income allocation.

KEY TAKEAWAYS:

- Bond funds typically produce positive returns if stocks are producing negative returns, but that has not held true for much of this year.

- Over time, as interest rates rise, the reinvestment of all maturities and coupons compounds at those higher rates, offsetting the current decline in bond prices.

- It is best to maintain a fixed income allocation in your portfolio that meets your long-term investment goals. It is impossible to perfectly time movements in interest rates.

- The purpose of a bond allocation in a portfolio is primarily to earn income and provide an investor with a potent diversifier against big stock market fluctuations, a normal part of any market cycle.

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Brent is a director of fixed income research for Commerce Trust Company. Upon gaining a thorough understanding of a client's needs and goals as well as assessing the client's entire financial situation, he works with our investment research team to construct a portfolio to help clients achieve their long-term goals. Brent comprehensively represents our research- and goals-based investment process, starting with the initial assessment and creation of an investment objective to ongoing evaluation and adjustments based on changing market and life circumstances. With a deep knowledge of the market and experience in investment management, he serves clients with thought leadership, insight, and consulting services. Prior to joining Commerce Bank in 1999, he spent five years as an analyst and assistant manager with the Federal Reserve Banks of Kansas City and St. Louis. He graduated with a bachelor of science in finance from Truman State University in 1994 and holds the Chartered Financial Analyst® designation. Brent is a member of the CFA Institute and the St. Louis Society of Financial Analysts.

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