March 2022 | Investment perspectives

Why fixed income still matters

Fixed income plays a key role in building a portfolio that balances risk and returns. We explore how this asset class can help diversify and protect your portfolio from market shocks.

Introduction

Fixed income investing is designed to give people a steady stream of income on a regular basis, usually in the form of a regular coupon or interest payment. It is often considered one of the safest ways to invest, avoiding the higher risk of the equity markets and the highs and lows of stock trading.

Even in today's historically low interest rate environment, fixed income remains an important part of an investor's portfolio and can offer many potential benefits. Spreading your investments and diversifying your portfolio away from equities with bonds can help protect you from any sudden dips in the market.

Bonds can also help you with capital preservation, a strategy that aims to prevent loss in a portfolio, especially for investors nearing retirement or their financial objective. They can also provide investors with attractive returns in relation to the amount of risk they have compared with other investments.

What are bonds?

The most common fixed income investments are bonds, which are fixed-term investments issued by governments and companies looking to raise money. A bond is essentially a loan made to a company or a government by an investor for a set period of time – usually a number of years.

The deal is that in exchange for handing over your cash you'll get a regular fixed rate of interest – known as a coupon. Once the bond's life comes to an end and it matures, your original capital will be paid back in full. Think of it as an interest-only mortgage, where you are loaning the money and expect to get it back, together with regular interest payments.

Most bonds issued by governments (we usually call these 'govvies') are considered low-risk investments as governments are less likely to 'default' on their loan payments (i.e. unable to pay back the interest or the amount borrowed) to bondholders. Two of the most popular 'govvies' are UK government bonds (called gilts) and US government bonds (Treasury bills).

Bonds issued by companies (commonly known as corporate bonds) are usually riskier than government bonds depending on the financial health of the issuer. However, they are usually safer than equities as you have full visibility of the coupon payments you will receive in the future. It is also worth noting that in the unlikely event that a company enters liquidation, bondholders usually get priortiy and therefore get paid back before equity holders.

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Why it pays to diversify

One way to lower risk when investing is by spreading your capital over a wider range of asset classes, geographical regions and industry sectors so it's not concentrated in one place – known as diversification. By diversifying your portfolio you can reduce the risk that all of your investments will fall in value at the same time.

Equity markets are often volatile (but remember this volatility can lead to good long-term returns), so when market conditions are challenging it is important to have investments in a diversified portfolio that can provide some level of protection. The idea is that when one part of a portfolio is struggling, another part can pick up the slack.

Bonds play an important role in a well-diversified portfolio by helping to reduce volatility. Historically, bonds are less volatile than equities, offering strong, positive returns when there are unexpected shocks or during periods of uncertainty.

At Omnis, our bond funds are actively managed, which means our investment managers can look at different sectors and different bonds to identify areas they believe have the highest return potential for the risk taken.

Bonds also offer advantages over gold and alternative assets. If you are invested in gold you will not receive an income, so to make any money you are reliant on its price rising.

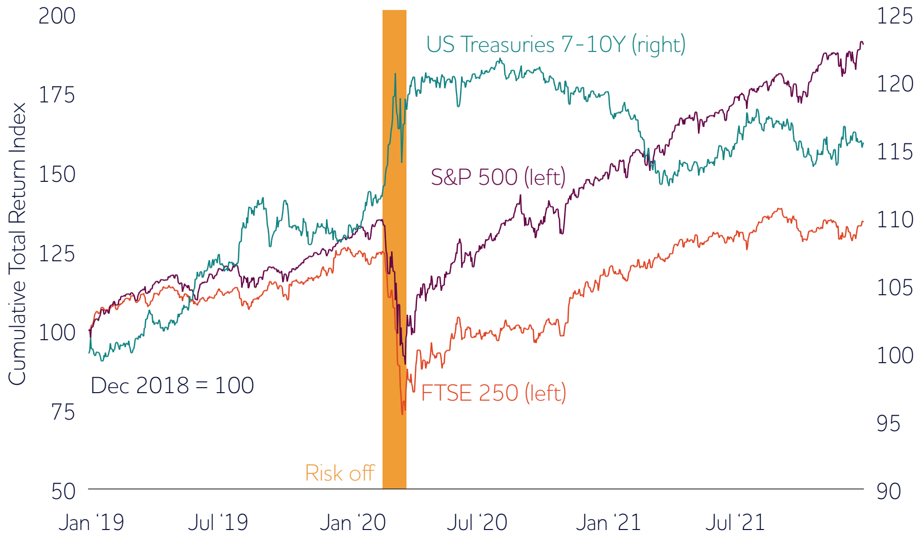
Alternative asset classes, such as real estate, might offer that long-term return potential but there is some difficulty in estimating valuations and how quickly you can access your money if you need it (known as liquidity).

Protect your portfolio

There's plenty of evidence to show that over the longer term equities are the most likely asset class to provide higher returns. However, they can be more volatile and less predictable in the short term, with investors often experiencing bumps along the way.

For example, the Covid-19 pandemic triggered one of the most dramatic stock market crashes in history in March 2020 (figure 1). After reaching a high in February 2020, the US S&P 500 Index fell by more than 30% in the space of a month.

Figure 1: How markets performed through the pandemic



Source: Bloomberg, Western Asset. As of 31 December 2021. US Treasuries 7-10Y are bonds issued by the US government that mature in 7 to 10 years | S&P 500 represents the US stock market - it includes 500 of the largest companies in the US | FTSE 250 represents the UK stock market and incorporates the 250 medium-sized companies in the UK outside of the FTSE 100 (Companies in the FTSE 100 are more exposed globally)

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Meanwhile, the FTSE 250 index of medium-sized companies, which is more focused on the UK economy, also tumbled. In response to the market turmoil, there was a flight of investors towards safer assets such as US Treasuries, which performed strongly over the same period.

For investors it was a worrying time as they didn't know when the volatility would end. Fortunately, equity markets recovered quickly, with stimulus measures and vaccine breakthroughs helping to send stocks roaring back to record highs during 2020.

When Russia invaded Ukraine in February 2022, stock markets around the world tumbled and volatility rose. Meanwhile, good-quality government bonds performed reasonably well as investors moved to put their assets in less volatile investments such as Treasury bills and gilts.

Crashes and drawdowns

During a stock market crash many of the world's major stock market indexes can lose more than 10% of their value in a relatively short space of time. This is what investors call a 'drawdown' – that is, the amount an investment falls from peak to trough in a given time period.

It can be useful to get an idea of what a typical drawdown might look like for a given asset class or investment, so that you can understand how volatile it is likely to be. Figure 2 shows the amount the S&P 500 has fallen from peak to trough over various time periods.

Market drawdowns can be sudden, severe, and extreme in duration. For example, the S&P 500 went down by 50.9% between October 2007 and February 2009 during the global financial crisis.

At the same, the US Treasury 10-year index grew by 18.5%. This performance highlights how you can minimise likely drawdowns and keep your portfolio's volatility to a level you are more comfortable with by diversifying with bonds.

Figure 2: Worst market drawdowns in recent history

S&P Peak	S&P Trough	S&P 500 Drawdown	FTSE 250	US Treasury 10+ Year Index	Bloomberg Global Aggregate Index (USD Hedged)	ICE BoA Global Broad Market Index (GBP Unhedged)
Oct 07	Feb 09	-50.9%	-42.8%	18.5%	7.0%	46.3%
Aug 00	Sep 02	-44.7%	-32.7%	32.0%	20.9%	14.1%
Apr 11	Sep 11	-20.3%	-13.7%	27.9%	4.7%	7.4%
Dec 19	Mar 20	-19.6%	-27.1%	18.1%	1.2%	5.1%
Jun 98	Aug 98	-15.4%	-17.8%	6.5%	3.0%	-0.2%
Sep 18	Dec 18	-13.5%	-14.7%	1.3%	1.4%	2.4%
Jul 15	Sep 15	-8.4%	-4.2%	5.0%	1.3%	5.0%

Source: Bloomberg, ICE BoA, Western Asset.As of 31 December 2021. Using monthly data from January 1997 to December 2021.

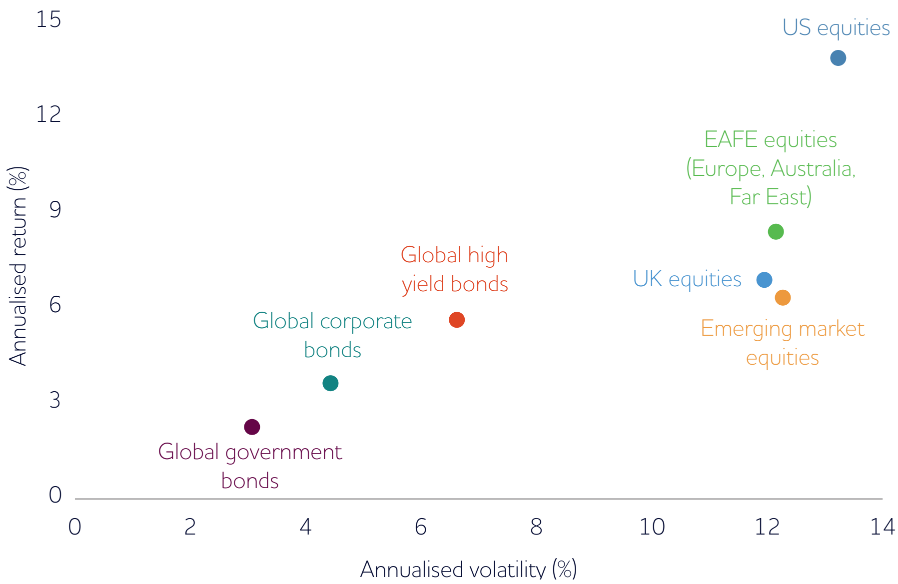
Better than you think

Fixed income does not just help balance your portfolio but can also deliver consistent returns compared with other asset classes such as equities. The risk/return profile (the relationship between the risk that an asset class is exposed to and the returns it generates) for bonds tends to be relatively attractive.

Generally, the higher the risk involved in an asset class, the higher the return. For example, while equities have the higher potential to generate income than bonds, the risk will also be higher.

Figure 3 shows that even though global bonds are a lower-risk asset than equities, they can still deliver strong returns. While equities have generally outperformed, they have multiple times the level of volatility of bonds.

Figure 3: Risk and return of different asset classes



Source: FE fundinfo – showing annualised returns and annualised volatility for major asset classes over 10 years to end February 2022. All calculations use Total Return in local currency – please note currency exchange rate fluctuations could impact the return you experience from each asset class. The following indices were used for each asset class: US Equities (S&P 500), EAFE Equities (MSCI EAFE), UK Equities (FTSE All Share), Emerging Market Equities (MSCI Emerging Markets), Global High Yield Bonds (ICE BoA Global High Yield), Global Corporate Bonds (ICE BoA Global Corporate), Global Government Bonds (ICE BoA Global Government)

A key part of your investment portfolio

Bonds are a great option for your portfolio to mitigate the unpredictability of stock markets. The right mix between equities and bonds will be dictated by your attitude to risk, which you will have discussed with your financial adviser. While many investors saw the value of equities plummet when the Covid-19 pandemic struck in March 2020, those who had fixed income in their portfolios were protected from the shock. This is because fixed income assets like bonds can help buffer portfolios against any sudden economic downturns or fluctuations in the market. Our bond funds invest in a broad range of actively managed fixed income securities, including corporate and government bonds, which help to diversify your portfolio.

In periods when stock markets deliver strong returns and bonds lag, it can be tempting to think that there is little value in holding bonds. However, as we have already seen this year, markets can be unpredictable and can be affected by economic and geopolitical events. That is why it is important to always have a well-diversified portfolios, consisting of different types of asset classes like equities and bonds in line with your risk profile. Always stick with the plan your adviser has set for you unless your circumstances change.