MCS
METROPOLITAN CAPITAL STRATEGIES, LLC

WHEN BONDS ARE NOT ENOUGH:
The Policy Portfolio in a No-Yield World

MCS White Paper **May 2013**

Executive Summary

- Fixed Income has a place in a policy portfolio because investors expect price gains during periods of equity weakness.
- In the current environment, bonds cannot deliver the same stabilizing effect as in previous bear markets unless long-term yields drop to zero or below.
- Family offices and other fiduciaries should consider reduced fixed income exposure in favor of alternative assets with better potential in the next equity bear phase.

Introduction

Family offices and other institutional investors frequently use a "Policy Portfolio" as the basis for strategic decisions. New investments are evaluated for their potential to enhance returns and/or reduce risk against the policy portfolio benchmark.

This "default option" can be a simple stock/bond balanced portfolio. The allocations vary but most policy portfolios have significant fixed income exposure – as much as 50%. In this brief white paper, we question conventional wisdom and ask whether a heavy bond allocation is still appropriate in light of historically low interest rates.

The Role of Bonds in a Policy Portfolio

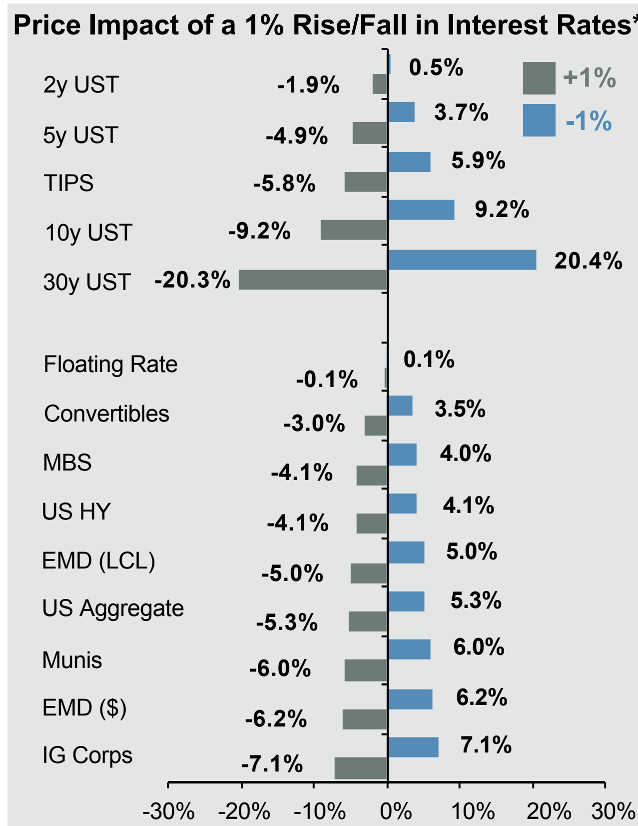
The long-term task for every investment fiduciary is to preserve and/or grow wealth. This wealth is normally owned by someone else. For a family office, the capital belongs to one or more affluent families. Foundations and pensions have more diverse constituents. In either case, the fiduciary must plan decades in advance.

Since no one knows the future, fiduciaries look to the past for guidance. Numerous studies show the historic benefits of a portfolio balanced between equities with bonds. We need not reiterate them

here. We will, however, repeat and emphasize a phrase usually found only in footnotes: ***"Past results are not necessarily indicative of future results."***

In the past, most equity bear markets coincided with positive or stable fixed income performance. Sovereign and investment-grade corporate bonds are policy portfolios not so much because their returns were impressive *over* time, but because their returns were impressive at the *right* times.

In other words, current yield is nice but not enough. Bonds need to deliver capital gains when equities deliver losses. In order for this to happen, bond yields must fall at those times.



This chart from JPMorgan illustrates the relationship between yield and price. In the ten-year Treasury, for instance, a one percentage point interest rate decline will result in a 9.2% price gain for existing bonds. Likewise, a one percentage point rate increase will reduce the same bond's present value by -9.2%.

With the ten-year Treasury presently at a sub-2% yield, we have a problem. Can bonds gain enough value to offset the next equity bear? It appears not, unless one presumes Treasury yields will drop below 0%.

The implications for fiduciaries are startling. Under current conditions, the foundation of many strategies cannot deliver the desired results. Yet institutional investors seem remarkably unaware of this new challenge.

Quantifying the Problem

In his March 2013 paper, *The Policy Portfolio and the Next Equity Bear Market*, Bill Hester of Hussman Funds asks whether bonds can again be the "automatic portfolio stabilizers" they were in previous equity downturns. He found bond exposure was most helpful in bear markets accompanied by falling inflation rates. With CPI persistently running well below average, inflation cannot fall much further unless it turns into outright deflation.

Hester compares today's nominal bond yield, real yield, and CPI with past bear markets and finds a stark difference. He then runs a "what-if" analysis to quantify the ability of bonds to deliver the same stabilization seen in past bear markets.

The answer is not encouraging. Here is Hester's conclusion in his own words:

Notice that unless interest rates were to fall to negative levels, investors cannot expect bonds to provide the same portfolio benefit as they have during bear markets in recent memory. From this analysis, those investors who are relying on a policy portfolio framework to protect their capital during the next bear market are left with a limited range of favorable outcomes. The best outcome would be a mild equity correction or bear market that coincided with a stable or falling rate of inflation. In this scenario, bonds could rally their standard 3 to 5 percent as stocks fell 15 or 20 percent. In this outcome, the balanced portfolio would likely avoid a little more than 40 percent of the decline the equity portion would experience.

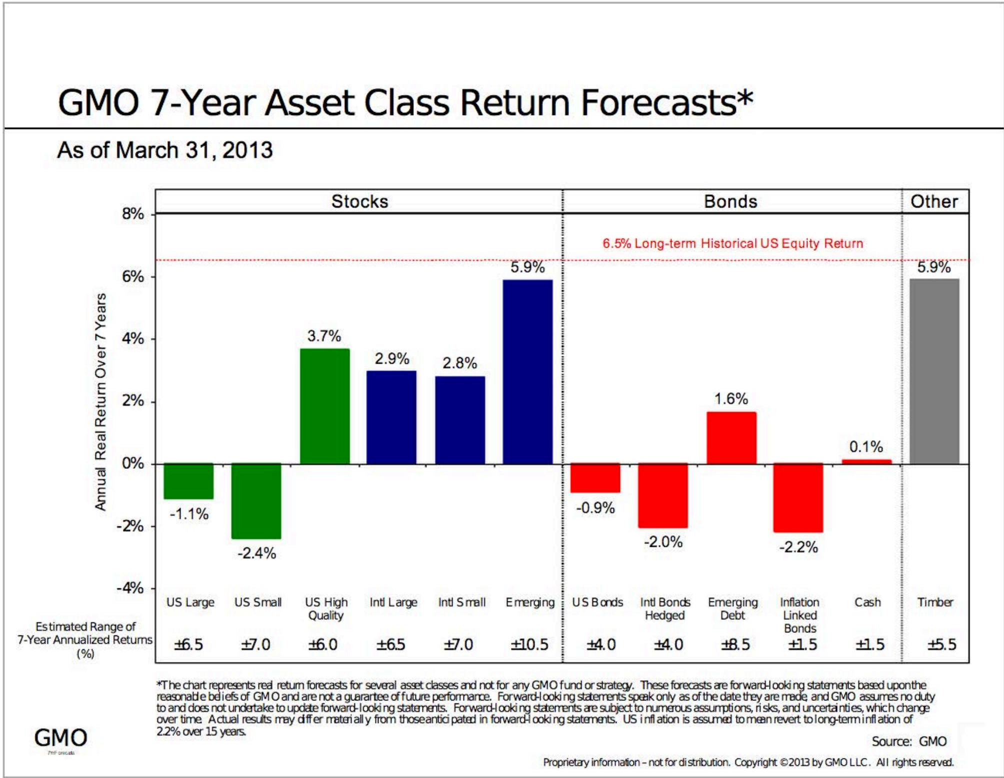
If a larger decline in stock prices were to occur, and for bonds to still defend against losses to the extent they have during the last two bear markets, yields on US Treasury notes would need to go negative. In data reaching back to 1871, this has never happened. That would likely result from an expectation for deep deflation. With stocks at currently high multiples on normalized earnings, that type of scenario would probably increase the odds off a deep recession and induce a much larger decline in stock prices.

As Hester explains, bonds helped institutions survive the 2007-2009 bear market by posting capital gains in excess of 20%. The 1980-1982 and 2000-2002 downturns showed even greater bond outperformance.

This combination of falling stock prices and rising bond prices is not repeatable under current conditions. The distance between current yield and zero is simply not enough. Mathematically, the bond portion of a policy portfolio cannot provide the same degree of protection as in the past.

Potential Solutions

The policy portfolio is simply a starting point for most fiduciaries. Whether or not they have considered this particular problem, they do not expect fixed income (or any other asset class) to carry the weight of a bear market alone. Alternatives exist and wise fiduciaries are aware of them. Hedge funds, commodities, private equity, and others are all on the table. The table below from Grantham Mayo van Otterloo (GMO), one of the largest institutional asset managers, illustrates their forecast for asset class returns for over the next seven years. Both traditional equities and bond portfolio returns are forecasted well below historical norms. A change to the traditional policy portfolio is necessary based on this forecast and in our opinion GMO is one of the thought leaders in using alternatives meaningfully in the portfolio.



Awareness, however, is not the same as action. We know domestic equity benchmarks are at new all-time highs. We also know that the Federal Reserve – with or without Ben Bernanke at the helm – *intends* to keep rates low for at least another year or two. Yet intention may not be enough to actually succeed in low rates.

To be ready for the next bear market, portfolio managers may need to further adjust their allocations. The optimal solution will likely require a shift away from fixed income in favor of the alternative portion of the policy portfolio.

Conclusion

If, as we have demonstrated, bonds cannot deliver their historical stabilizing effect under current conditions, something else must take on the job. The *parameters* of the solution will vary for each fiduciary. The *necessity* for a solution will not.

Disclaimer: The views expressed herein are those of MCS as of May 21 2013 and are subject to change at any time based on market and other conditions. This is not an offer or solicitation of the purchase or sale of any security and should not be construed as such.