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Bonds and diversification

Bonds play a number of important roles in an investment portfolio. Bonds offer a reliable income stream in the form of coupon payments, which comprise the bulk of total returns. High-quality bonds are also used to preserve capital and provide greater certainty for investors. Additionally, bonds are an excellent store of liquidity, thanks in part to funds that make bond exposure accessible for everyday investors.

But there's another reason why bonds are considered important in a balanced portfolio: they can reduce risk by diversifying away from share markets. Because returns from shares and bonds are driven by different factors, a diversified portfolio that includes both shares and bonds will provide greater stability over time compared with a pure equity portfolio.

Bonds and shares have low or negative correlation

The prices of bonds will fluctuate according to interest rate movements and economic cycles, but historically they are not nearly as volatile as shares. In fact, high-quality bonds tend to perform well when share markets head south, thereby dampening losses in a balanced portfolio. This is what analysts are referring to when they say there is a low or negative correlation between the returns of bond markets and share markets. It is this low or negative correlation that provides the diversification every well-balanced portfolio needs.

Figure 1. How bond portfolios behave through different market conditions

Economic uncertainty / bear market

- Deterioration in growth outlook leads to a fall in interest rates and rise in bond values.
- Uncertainty produces share market volatility and risk-off mentality.
- Investors shift from risky assets like shares to safer assets like high-quality bonds.
- Share and bond performance diverges, resulting in low or negative correlation.
- Low or negative correlation dampens losses in a diversified portfolio.
- Investors enjoy greater portfolio protection in exchange for some upside in returns during bull markets.

Economic certainty / bull market

- Improvement in growth outlook leads to a rise in interest rates and a fall in bond values.
- Degree of certainty and market stability produces risk-on mentality.
- Investors shift from safe assets like high-quality bonds to risky assets like shares.
- Share and bond performance diverges, resulting in low or negative correlation.
- Low or negative correlation dampens gains in a diversified portfolio.
- Investors forgo some upside in returns for greater portfolio protection during down markets.

Can bonds still deliver diversification when yields are low?

Bonds will naturally come under greater scrutiny when yields are low, and some may question the value of bonds in a long-term financial plan. Some have argued that persistently low yields and low income not only dampens overall portfolio returns in normal times but also accentuates the limitations of bonds as effective equity shock absorbers.

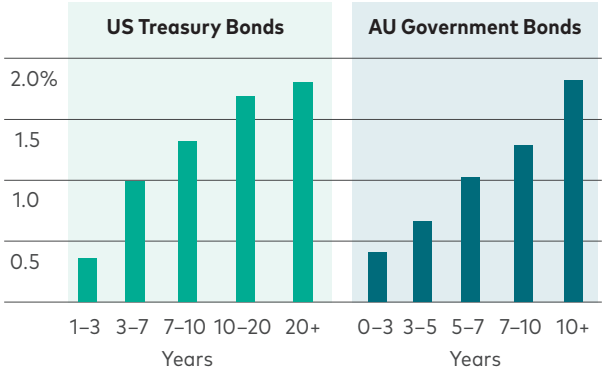
While low yields may see returns for balanced portfolios run below their long-run averages, it isn't necessarily the case that bonds lose their diversifying effect. Even during periods when yields have been close to historic lows, bonds have offered good diversification when equity markets become turbulent. And if there is one lesson to be learnt from history, it's that uncertainty induced volatility can happen at any time.

Bonds can fund opportunities when they emerge

Bear markets are always painful for investors. But when equities are selling off, opportunities can emerge. Companies that once seemed prohibitively expensive are suddenly available at more attractive prices. Bonds offer protection during a market storm, but they also provide a source of funds to draw on when it's time to buy. It can never hurt to have some dry powder in your portfolio.

Figure 2. Why invest in broadly diversified funds

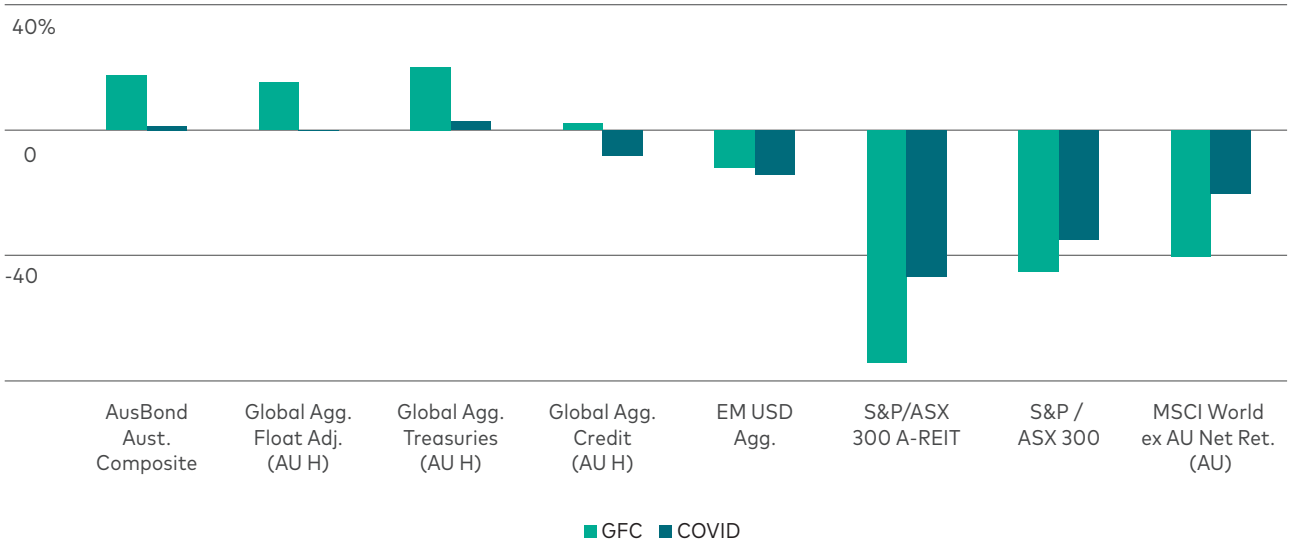
Median monthly asset returns during worst quartile periods of equity markets for the respective Australian and U.S. markets — 20 years to 31 December 2020.



Asset returns during perids of worst quartile equity markets for the respective Australian and US markets.

Source: Bloomberg. Data as at 31 December 2020.

Figure 3. Fixed Interest index outcomes in recent equity drawdowns – GFC to COVID



Source: Bloomberg

Notes: GFC is from 12 October 2007–9 March 2009. COVID drawdown is from 20 February 2020-23 March 2020. Indices are Bloomberg AusBond Australian Composite 0+ Yr ; Bloomberg Global Aggregate Float Adjusted Total Return Index Hedged AUD; Bloomberg Global Aggregate Treasuries Total Return Index Hedged AUD; Bloomberg Global Aggregate—Credit Total Return Index Hedged AUD; Bloomberg EM USD Aggregate Total Return Index; S&P/ASX 300 A-REIT Total Return Index; S&P / ASX 300; MSCI World ex Australia Net Return in AUD

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