LEWIS
WEALTH MANAGEMENT

Newsletter

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<u>Executive Summary</u>

Bonds have been a thorn in the side of investors in the past few years — especially last year.

The purpose of bonds in a portfolio is to (1) reduce overall portfolio volatility and (2) earn income.

Despite recent performance setbacks, bonds still provide a good way to reduce overall portfolio volatility.

However, bonds have not been a good source of income, as interest rates were at historically low levels, but that has improved lately.

For these reasons, bonds still have a role to play in a good asset allocation. I keep searching for alternatives, but the ones currently available are adding, not mitigating, portfolio risk.

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Market Data as of June 30, 2023

		YTD 2023
US Equities	S&P 500 ETF	16.83%
International Equities	MSCI EAFE ETF	12.03%
Emerging Markets Equities	MSCI Emerging Mkts ETF	5.12%
US Bond Market	iShares US Core Bond ETF	2.26%
Commodities	S&P GSCI Comm ETF	-8.11%
Real Estate	iShares US Real Estate ETF	3.85%

The Case for Bonds

Last year was the worst year for bonds in modern economic history. The overall bond market, as measured by the Bloomberg Aggregate Bond Index, was down a shocking -13% last year.

To put that into perspective, since 1976, there were only four other years when performance was negative: 1994 (-2.9%), 2013 (-2.0%), 2021 (-1.5%), and 1999 (–0.8%). Otherwise, performance was positive in 41 of the previous 46 years.

The average performance for bonds from 1976 to 2022 was 6.6% per year. But performance has recently been lower. In the past ten years, overall bond performance has averaged only 1.3%.

Investors are understandably frustrated. Should we sell some of our bonds, or eliminate this asset class entirely from our portfolios? Let's take a look.

How Do Bonds Work?

Bonds are a form of debt issued by a company or government that wants to raise cash. In essence, the bondholder is loaning money to the bond issuer. In exchange for the loan, the issuer promises to make interest payments to the holder at regular intervals, usually semiannually, and then repay the original principal at maturity.

You can purchase bonds individually, or you can hold them in a mutual or an exchange-traded fund. Bond funds are an effective way to achieve diversification while gaining professional management. That said, individual bonds can be attractive, especially if they are highly rated and you plan on holding them to maturity.

There are many types of bonds: government, corporate, municipal, and international. They come in different durations: long, short, and everything in between. They also come with different credit risks: from low-risk government bonds all the way to corporate junk and emerging market bonds.

Despite their recent performance, I still believe there are two primary reasons to include bonds in your portfolio: (1) to reduce volatility and (2) to collect income.

<u>How Bonds Reduce Portfolio Volatility</u>

Bonds are generally less risky than stocks. This is because it is quite easy to see the cash flow a bond will produce until maturity. Unless the bond defaults, you know what you are going to get and when you will get it.

This is not the case with stocks. With stocks, we can only forecast what future cash flows will look like. We do not know with any degree of certainty what the future earnings of a company will be. For this reason, stocks are generally riskier than bonds.

Because of that higher risk, expected returns on stocks are higher than on bonds. We can see that in historical returns.

Average Annual Returns

	2018-2022	2012-2022	2002-2022	Since 1976
Stocks – S&P 500	11.4%	12.9%	8.0%	11.4%
Bonds – Bloomberg Aggregate	0.0%	1.3%	3.4%	6.6%

Because the expected returns on stocks are higher, bonds are generally considered less risky than stocks. We can see that by looking at historical standard deviations (a measure of risk).

Risk – Measured by Standard Deviation

Stocks – S&P 500	18.01%
Bonds – Aggregate	6.13%

Overall, on a long-term basis, stocks have a standard deviation of 18.01% (the higher the number, the higher the risk), and bonds have a standard deviation of 6.13% (the lower the number, the lower the risk). By this measure, stocks are about 193% more risky than bonds. On the other hand, from 2002 to 2022, stocks provided 135% more return — fair compensation for the additional risk.

Because of their different risk and return profiles, stocks and bonds are often combined to create a portfolio with certain risk/return characteristics. You can see that here.

Average Annual Returns – Hypothetical Blended Portfolios – 2002-2022

	100% Bond	40%/60%	60%/40%	100% Stock
Return	3.4%	5.24%	6.16%	8.0%
Risk	6.13%	10.9%	13.3%	18.01%

Bonds can be helpful in portfolio construction. For most investors, investing in a 100% stock portfolio could be too risky, but a 100% bond portfolio does not provide enough return. That is where blending stocks and bonds in certain asset allocations can help investors fine-tune their portfolios while working toward their financial goals.

Bonds as a Source of Income

The second reason to include bonds in a portfolio is to create a steady stream of income by simply collecting the coupon payments on the bonds in your portfolio.

Are bonds a reliable source of healthy income? No — they haven't been for some time, unfortunately.

While the concept sounds great, bonds have not been a very good source of income for a while. This is due to the historically low interest rates we have experienced in the past 20 years. Here is a chart of the average yield on the 10-year Treasury Bond every five years from 1970.

Average Yield on a 10-Year US Treasury Bond

1970	7.35%
1975	7.99%
1980	11.43%
1985	10.62%
1990	8.55%
1995	6.57%
2000	6.03%
2005	4.29%
2010	3.22%
2015	2.14%
2020	0.89%
2022	2.95%

Source: macrotrends.net

As you can see, we have been languishing in a long period of low yields. However, yields have been rising recently, as the Federal Reserve has been raising interest rates. New bonds finally have more attractive yields. Of course, we don't know how long this will last.

Overall, bonds have not been providing much income for a while. Currently, this is a less-compelling reason to own bonds other than reducing risk in a portfolio.

Investing in Bonds

There are certain risks that must be considered when investing in bonds.

Interest rate risk is one of the most important. Interest rates and bond prices are inversely related. We experienced this last year. When the Federal Reserve quickly raised rates, the value of existing bonds dropped dramatically. Of course, the opposite can also be true. If the Fed lowers rates, the value of existing bonds will rise — and that may very well happen in 2024.

There are other risks to consider: default risk, inflation risk, and reinvestment risk, to name a few. These risks must be considered when investing in bonds.

The Bottom Line on Bonds

For some time, I have been using bonds as a way to reduce overall portfolio risk and volatility. Unfortunately, bonds have not provided a good source of income in recent years, although that has started to change. It is now possible to obtain some decent income on your bond portfolio. ***While the yield curve is inverted, it makes more sense to focus on short-term bonds right now. Longer-duration bonds are less attractive.***

Yes, bonds took a very big hit last year, but many expect bonds to do better in the next few years. It is difficult to say. And if you decide to trim or eliminate your bond portfolio, how do you plan on investing that money? ***Most investors would turn to stocks, private investments, real estate, or other risky asset classes, which would measurably increase the overall risk of their portfolios.*** During the next bear market, they could experience a large setback, which could jeopardize their long-term goals. In my view, there is not a good risk-adjusted substitute for bonds right now, but I keep looking.

Overall, I still believe that bonds play an important role in a portfolio and should therefore be included by most investors.

If you have questions about your portfolio or your long-term financial plan, give us a call.

Thank you.

D. Austin Lewis

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