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TRANSCRIPT

The Role of Bonds in Multi-Asset Portfolios

Featuring:

Andy Sparks, Head of Portfolio Management Research, MSCI

Jenna:

Joining us now to share his thoughts on the role of bonds and multi-asset portfolios is Andy Sparks, Managing Director, MSCI Research. He'll give an overview of the current environment, the focus on climate change, and how investors might adapt to the changing landscape to create opportunities. Andy, great to have you with us. For starters, what have we learned about the bond market since the onset of the COVID crisis?

Andy:

Thank you, Jenna. Very nice to be, once again, on Asset TV. And the crisis is tragic as it's been has been a huge learning opportunity for financial market participants, and I say liquidity is one of the big issues that has been underscored to us. And so, in March 2020 at the onset of the COVID crisis, there was, of course, tremendous market volatility, and there is very significant deterioration in market liquidity. And this was true not just in equities and corporate bonds but also in the US Treasury market, a market we normally think of as being among the most liquid in the global capital market. So liquidity is not as deep as I think a lot of people thought it had been prior to the crisis. We've also learned a lot about the Fed's reaction function, most particularly, it's willingness to seemingly do almost anything to stabilize markets. Massive monetary stimulus via purchases of US Treasuries in [inaudible] has generated most of the headlines, but the Fed's support of the corporate bond market has also been unprecedented. And it appears to have been very successful at helping to stabilize the sector. So that's another important lesson, I think, of what we've learned since the crisis. And then another big one is something that's really been underscored during 2021, is that inflation is alive and well. And this year we've seen inflation hit its highest level in 30 years. And although the current market expectation is that inflation will come down and be close to the Fed's 2% target, the spike we've seen this year serves as a reminder to investors that inflation is very much a factor to pay close attention to.

Jenna:

Yeah, inflation is alive and well as you said. The key question, though, is, will it be transitory as the Fed has indicated? Now, given low interest rates and increased inflation, how should investors think about bonds?

Andy:

The reality is that, after adjusting for market inflation expectations, yields on US government bonds are negative. They are most negative at the short end of the real yield curve, but even for longer maturities, they are significantly negative. So this is a challenging dynamic that bond investors must be grappling with. And so, what is an investor to do? Well, a bond market skeptic might say to move into other sectors such as equities. On the other hand, supporters of the bond market may argue that equity market valuations also appear very high. And bond supporters may also point to historical evidence showing that bonds have served as insurance against equity market volatility. In this way, bonds have played an important role in stabilizing returns and serving as an anchor in multi-asset portfolios.

Jenna:

Are bonds still that anchor in a portfolio, Andy?

Andy:

Yeah, that's a hugely important question, Jenna, and let's focus a little bit on 60/40 portfolios, as these are portfolios with the 60% allocation to equities and a 40% allocation to bonds. This is a very popular investment paradigm for many investors. And the growth and the success of the 60/40 paradigm is precisely due to the role that bonds have played in stabilizing multi-asset portfolio returns. And so, since 2020, bond returns are much diminished compared to previous decades while equity returns since 2020 have been very strong. And, nevertheless, risk-adjusted returns on the 60/40 portfolio are also high, and, interestingly, are actually higher than the risk-adjusted returns we've observed on equities since 2020. And so, the strong performance of the 60/40, recent strong performance, partly reflects the role that bonds have played in offsetting equity market volatility since the onset of the COVID crisis. In other words, bonds, particularly US Treasuries, have tended to rally at the same time that equities have sold off. In technical terms, this is referred to as negative correlation between bonds and equities.

Jenna:

Yeah, typically, they do move in opposite directions, that negative correlation that you mentioned, but, Andy, what could cause this correlation to turn positive?

Andy:

Well, our research suggests that inflation, particularly unexpected inflation, as well as inflation volatility, may be a key issue to focus on. During the '70s and '80s, when inflation was high and variable, the correlation between bonds and stocks was positive. In other words, when equities sold off, fixed income also tended to sell off in those decades. So we model potential changes in the bond equity correlation by whether inflation volatility rises in the future. So under a regime of a strong Fed where inflation is under control, we would model the correlation as continuing to be negative, but in a situation where inflation rises and the Fed seems to lose control, we modeled the correlation as turning positive. In this scenario, the insurance value of bonds in a multi-asset portfolio will be much diminished. So a really important question now is, looking forward, will inflation be tame? And will the bond equity correlation be negative? And, look, I don't have a crystal ball, but I will point out that market-implied inflation expectations have declined from their highs, achieved this past May, and are now largely consistent with the Fed achieving its 2% inflation target over the longer term. So, in other words, despite this year's inflation spike and despite the Fed's massive monetary stimulus since the onset of the COVID crisis, the market seems to have confidence that the Fed will be able to keep inflation in check.

Jenna:

Yeah, and we have seen some signs of that stabilizing with lumber prices the month-over-month cord. CPI numbers seemed like they were cooling maybe slightly, so we'll have to wait and see there.

Andy:

Definitely.

Jenna:

And as a result of the COVID crisis in the news of more frequent natural disasters around the globe, the focus on risks from climate change is front and center. We just can't ignore it anymore. What's your thinking around creating more climate-aware portfolios?

Andy:

Yeah, this is a really important issue, and let me just start by saying that we're really in the early days in climate investing and a huge amount of education is required. There has been this upsurge in interest, and some commentators are even comparing it to providing financing for the next industrial revolution. So to state the obvious is this could be a huge development for the capital markets. And the reality is, is that changes in public policy and investor-driven climate initiatives could very significantly redirect the flow of investments toward greener companies and technologies that limit carbon emissions. As a result, the transition to a low carbon economy may impact stock and bond prices, presenting investors with potential risk but also with opportunity. We have written several blogs on the topic of climate investing from the perspective of bond investors. We compared corporate bonds to equities to try to better understand the climate risks, yes, and the opportunities that bond investors face. In these blogs, we focused on a hypothetical investor who uses climate analytics to build bond portfolios which may provide protection against climate risk. The specific scenario we analyzed is a policy-driven scenario designed to limit the increase in global temperature to 1.5 degrees Celsius by the year 2100. Our scenario also allowed for the possibility that some bond issuers may benefit from emerging green technologies. One of our most basic results is that all sectors we analyzed, equities, investment-grade corporates, and high-yield corporates have significant potential downside market risk resulting from changes in climate policies. Equities had more exposure to climate risk than investment-grade corporates. This was not surprising to us because of the role of capital structure. In particular, since an issuer's equity securities are the first exposed to downside risk and bonds get impacted afterwards, we generally would expect equities to carry more climate risk. Now, we did find that for the investment-grade sector compared to equities, but one surprising result in our analysis is that the high-yield corporate bond sector showed significantly greater exposure to climate risk than equities. And it turns out, a primary reason for this has to do with differences in sector concentration. Specifically, the high-yield asset class has much higher—Excuse me, the high-yield asset class has much higher exposure to the energy, materials, and utility sectors. And these are sectors contributing very significantly to climate risk. In contrast, equities have a much higher concentration in technology and financials, and these are sectors which carry a relatively small amount of climate risk. So that finding with high-yield was one surprise. Another surprise we found is that, in our analysis, our hypothetical portfolio managers were able to rebalance their—they were able to create new portfolios by rebalancing their existing portfolios. And to achieve new portfolios that did achieve substantial reductions in climate risk without significantly changing their portfolios' risk, from changes in interest rates or spreads. Further, the newly rebalanced portfolios had similar yields and spreads as the original portfolios. So this suggests to us, and I think this is an important result, this suggests to us that climate investing does not yet appear to have had a major impact on bond market pricing. And so, for investors looking for opportunities within the fixed income market, we believe that climate investing offers some very interesting possibilities. So that was pretty much what our analysis of climate investing from the perspective of bond investors revealed.

Jenna:

Really interesting research there and something that it seems like investors are just paying more and more attention to. What else should bond investors be focused on, going forward?

Andy:

As they say, only the paranoid survive. And there are lots of worries that keep bond investors awake at night, but I would say that policy is really crucial here. And we have fiscal policy, we have monetary policy, and we have climate policy. And there is a change in dynamic for all of these. And so, further fiscal stimulus, aggressive fiscal stimulus could put pressure on inflation. Monetary stimulus or monetary tapering could also affect inflation and, therefore, affect market pricing a lot. And so, I think the market is laser-focused on inflation these days, as well, it should be, but I think it's important to try to extract the signal from the noise. And there has been a lot of short-term noise in the inflation readings because of the artificially low levels of prices at the very early stages of the COVID crisis. And so, I think a lot of the focus should be on inflation, but a lot of the inflation risk will ultimately be driven by policy risk and policy makers in Washington, at least for the US. And I would say climate policy is a big—there is a lot of ambitious policies that are being talked about, and we're heading into the COP26 conference in Glasgow in November, and there will be a huge amount of new policies announced then, but I think where the rubber really hits the road is where these policies begin to get implemented and moved from just being at a high level with broad announcements to being actual regulatory policies that institutions and investors must be following.

Jenna:

Seems like there is a lot in the pipeline from a policy perspective, Andy.

Andy:

There is, but there is also a lot in the pipeline from a non-policy perspective too. So there are other things to be focused on as well. And I come back to the comment I made at the beginning part of the interview about liquidity and bond market liquidity, and I think quite a few participants were disappointed at the lack of market depth during the early stages of the crisis. And I think there is a lot of innovation going on around liquidity, and a lot of it has to do with market structure, including things such as ETFs, and greater popularity of the ETFs, not just as an investment vehicle but also as a trading vehicle. And it's a way to get quick exposure to the fixed income market, either reducing exposure or adding to exposure. ETFs, gradually, over the years, they've become more and more used as trading vehicles which, again, is one direct response to liquidity. And I think that from a portfolio construction perspective, I think that there is more and more emphasis on finding ways to improve the liquidity portfolio—excuse me, the liquidity profile of bond market portfolios. Another topic is factors. And we've seen in equities that factor investing has come to dominate a lot of the paradigm. And it's not really taken of yet in fixed income, and there are attempts to do it. I don't know how long that will take, but I am confident that over time, that you will see more quantitative strategies based on factors in fixed income. And something else that I think is very important for investors to keep in mind: I think, really, the COVID crisis is a good reminder that it's good to be humble as an investor, and it's also good to recognize that every crisis is a little different. And stress-testing is, I think, a very useful way of looking at potential economic scenarios in the future that have never occurred in the past. And so, I think stress-testing is a good way to complement portfolio management, and to the extent that an investor is concerned about a particular scenario. It could be a health crisis, it could be a stock market crash, whatever. There are ways of looking at how portfolios would behave in those sorts of scenarios. And I think those tools and the use of those tools and the necessity of them has been underscored by what we've gone through over the past year and a half.

Jenna:

Very useful, necessary, and tumbling, as you mentioned. Well, Andy, appreciate you sharing your insights on the role of bonds and multi-asset portfolios as investors prepare for the remainder of 2021 and beyond. Thank you so much for joining us today.

Andy:

Thank you very much, Jenna.

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