

One Point One Per Cent

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Investors, both individual and institutional, have in the past often utilized a benchmark asset allocation of 60% equities and 40% fixed income securities. This benchmark, in turn, is frequently composed of two widely used indices: The Standard and Poor's 500 Index for equities, and the Bloomberg Barclays US Aggregate Bond Index ("US Agg") for fixed income. Our view is that this benchmark asset allocation is no longer viable for most investors, and that investors have no choice but to investigate alternative asset allocation structures. The reason for this is the severe and unprecedented deterioration in the forward return potential of investment grade fixed income securities.

Below is a summary of annualized returns for the US Agg:

Bloomberg Barclays US Aggregate Bond Index (through August 31, 2020)	Annualized Returns			
	1 Year	3 Years	5 Years	10 Years
	6.4%	5.1%	4.3%	3.7%

These realized returns, particularly the one and three-year return, may well be acceptable to many investors, but they cannot be used as baseline forecasts of future returns. The reason for this is simple: bond prices have benefitted from falling interest rates, and particularly benefitted from the decline in interest rates triggered by the coronavirus pandemic. This phenomenon is unlikely to repeat itself as the pandemic ends and the economy recovers.

The actual yields presently available for investment grade bonds are a much sounder basis for forward looking forecasts than historical returns. Short term rates today are near zero. The 10-year treasury yield closed at 0.71% in August. As this is being written the actual yield on the US Agg is 1.1%. In a study conducted by economists at JP Morgan¹ they came to the conclusion that there is a very tight fit between the 10 year rolling US Agg returns and the starting Internal Rate of Returns ("IRR") of US Agg. They also estimate that the starting IRR of the US Agg equals the cap weighted average of US Treasury: yield; Mortgage Backed Securities (MBS): yield minus 27 bps (due to negative convexity); and High Grade

(HG): yield minus 40 bps (to account for credit downgrades to high yield). Based on this analysis, the best estimate for 10 years forward returns for the US Agg index is 1.0%. For an individual investor, the management fees would only detract from this prospective return on the fixed income component of their portfolio. If the advisor places 40% of the investor's portfolio in a bond portfolio similar to the US Agg, the 1% earned on that segment of the portfolio would earn an after-fee annual return that would potentially be as low as zero percent. This return is low and significantly below the rate of inflation targeted by the Federal Reserve of 2% per annum. Even if the management fee on this segment of the portfolio were to be reduced to 0.2%, which would seem fair given likely returns, the investor earns only 0.8% net per year. The conclusion here is that anything close to a 40% allocation to traditional investment grade fixed income will not work for the investor after prevailing management fees or even a reduced fee.

For Institutional investors the dilemma is similar. Public pension funds have lowered portfolio return assumptions in recent years, but assumed returns still exceed 7% for most funds. Foundations often generally seek net returns in excess of the 5% required annual distribution. For these investors, a forward return of less than 1% per annum for any significant portion of assets generates a huge obstacle to meeting objectives.

Alternatives must instead be considered. High yield or "junk" bonds are one alternative, but a 40% allocation to high yield generates significant risk and lack of diversification. When the economy contracts, leveraged companies tend to suffer more profoundly than financially strong companies. We believe that in addition to high yield, hybrid securities such as convertible bonds will provide an important solution to the "One Point One Per Cent" dilemma. In addition, so-called "liquid alternative" strategies, that incorporate strategies used by hedge fund managers, will play an important role.

Investors must avoid being fooled by the relatively high returns investment grade fixed income securities have generated in a period of falling interest rates and direct government intervention in the treasury bond market. Getting anything close to these past returns from the current bond market is a remote possibility at best. Liquid alternative strategies must be revisited. Attaining goals will be dependent on identifying active strategies and managers capable of navigating challenging markets and delivering for investors.

¹Jan Loeys, Shiny Kundu "The Long-term Strategist 60/40 in a zero-yield world" JP Morgan Global Markets Strategy 6/30/2020

Unless otherwise stated, statistics included in document sourced from Bloomberg Barclays.

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