Building a better bond portfolio

Slow growth and wild economic swings mark the investment world in which we live and investment portfolios need balance more than ever.

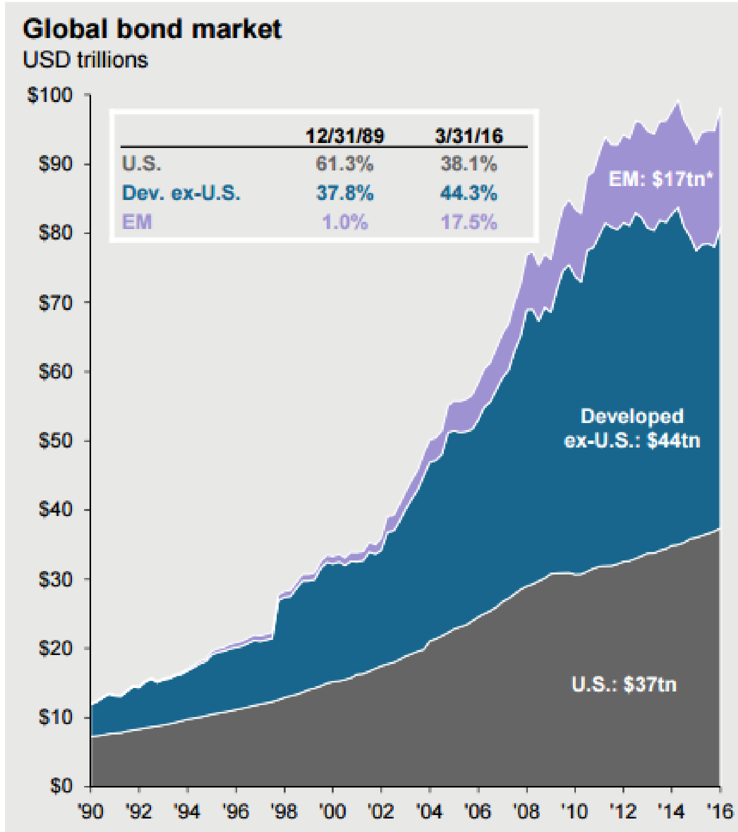
At Hemenway Trust Company, we believe a diversified portfolio of high quality stocks provides the best long-term risk-adjusted returns and will generate a growing stream of dividend income that will far outpace the growth of inflation. We realize stocks are long duration assets and 1) clients have short term liquidity needs and 2) even small changes to expectations on the economy or an individual company can have a major impact to stock valuations. We use bonds to alleviate some of these issues and still believe traditional bonds play a critical role in a long term investment portfolio.

Banking on bonds

A bond is an investment in which an investor loans money to an entity (typically corporate or governmental) for a defined period of time at a variable or fixed interest rate. Bonds are used by companies, municipalities, states and sovereign governments to raise money and finance a variety of projects and activities. Historically, bonds have generated a stream of income in line with inflation expectations and a bond's value will be dictated by the credit worthiness of the issuer and prevailing interest rates. Most know that, all else being equal, if interest rates increase, bond prices go down, as newer bonds with higher yields are deemed more attractive. That being said, with a steady decline in rates over the last 35 years, most of us have not been through a cycle of rising rates. In 1981, a 10-Year Treasury note was 15.84%; today it stands at 1.7%. These low rates have made bonds a cheap financing source and have pushed the current U.S. bond market size to $40 trillion, with another $60 trillion in bonds outside the U.S.

The investment community at large is conflicted about bonds in this seemingly eternal low rate environment. Common wisdom is that with rates so low, bond yields do not justify any investment at all; as Bloomberg notes, "Sub-zero bond yields are causing all sorts of headaches for investors, since those who buy now and hold until maturity will receive less money than they paid."[i]

Our view, however, is that smart bond selection overcomes those objections. High quality bonds here in the U.S. give us a defined timeline and near-guaranteed return – however low – that we can count on when planning for future liquidity needs. We "ladder bonds" so that we see maturities coming due every three to six months, allowing for a rolling inflow of cash that either can be reinvested into new bonds, reallocated into the equity portion of the portfolio, or used to address immediate cash needs.



Source: J.P. Morgan Asset Management

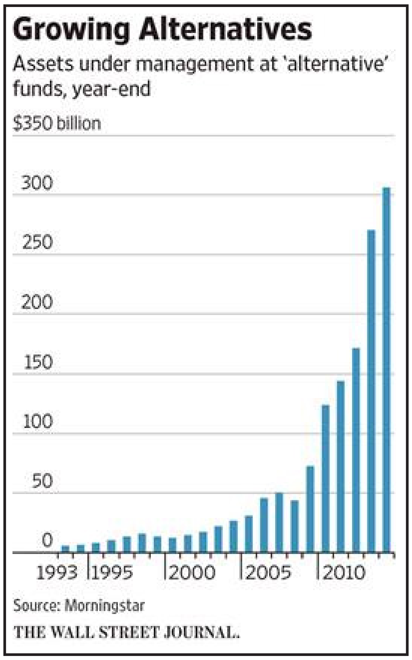
In addition to liquidity, bonds provide much needed ballast to a portfolio. Barring a default, the return on an individual short/intermediate bond will likely range between +3% to -3% in a given year, whereas a stock's return range can be significantly wider. That means if the markets plummet, the bond allocation will remain relatively stable. As Money magazine points out, "[bonds] provide a diversification benefit that may be more powerful than ever before…correlations between stocks and bonds tend to stay low during periods of sluggish growth and low inflation, which pretty well describes the current economic outlook."[ii]

The right bonds make all the difference. When it comes to bond selection, we look heavily to highly rated corporate bonds. While they do not have the same return expectations as high yield bonds, they have the lowest default rates and are in the highest demand when equity markets are in stress. There is also more visibility into the true risk associated with these company issues, compared to a government or municipal bond that can be equally driven by politics. This is a crucial point, as Hemenway Trust Company does not rely only on credit agencies, but will conduct its own due diligence to assess a bond's strength.

And more recently, we have been asked to tailor bond portfolios to align with clients' social viewpoint. For example, we have clients where we exclude bonds from issuers in the energy extraction, genetically modified and packaged food business, and overweight bonds with strong ESG (Environmental, Social and Governance) scores with a focus in education and energy efficiency.

Avoiding the reliance on Hedge Funds

Over the past five to ten years, the fear of rising interest rates on bonds has pushed clients and advisors to a fresh crop of hedge funds that promise fixed income-like returns and volatility without the interest rate risk. Most of these funds have limited transparency, high fees and use complex investment strategies relying on derivatives and leverage. It's important to note that most of these funds may make concentrated bets that can see significant losses in a short time period. While some of these funds may be appropriate in a diversified portfolio, we feel they add a whole new set of risks and should not be considered a substitute for traditional bonds.



Staying true to the bond philosophy

We cannot predict where rates will be ten years from now, but history has shown us that a prolonged low rate environment is no indication that we've reached the bottom. Even as other advisors rely on hedge funds to chase returns, we stand by our core philosophy of building high quality bond portfolios that complement equities and provide a steady stream of reliable income.

Endnotes

(i) http://www.bloombergquint.com/markets/2016/08/10/negative-yields-have-turned-bond-trading-into-a-commodity-market
(ii) http://time.com/money/4460676/why-bonds-a-better-deal-than-you-think/