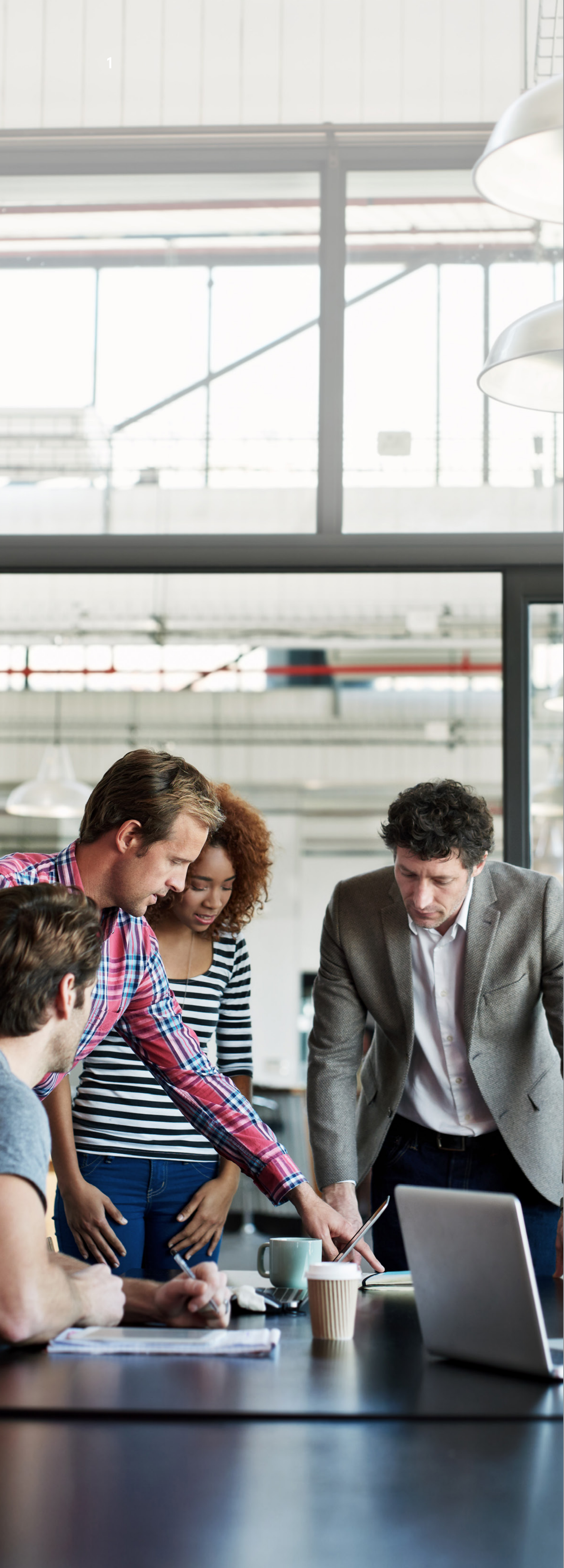

WILL BONDS BAIL YOU OUT NEXT TIME?

PHIL EDWARDS

With equity markets reaching new highs and bond yields remaining extremely low by historical standards, portfolios dominated by equities and bonds that have worked well over the past eight years are likely to face material headwinds over the next five to 10 years. These include low forward-looking return expectations given starting valuations and the potential for a change in the behavior of equities and bonds under certain economic scenarios.

In particular, the diversification benefit provided by the negative correlation between equities and bonds over the past decade or so may not persist. A potential catalyst for such a change could be a shift toward a more inflationary environment in which tighter monetary policy and rising bond yields undermine the returns of both equities and bonds. Although higher levels of inflation are far from inevitable, we believe that the shift in policy discussions toward fiscal stimulus (evident in Canada, Japan, the US and, to a lesser extent, in the UK and Europe) at a time of synchronized global growth raises the likelihood of inflationary pressures emerging over the medium term.

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Figure 1 illustrates the rolling three-year correlation between the S&P 500 and US Treasuries. This shows that while equity-bond correlations have been broadly negative since the turn of the century, the correlation was positive for decades before this.[1] This raises two important questions:

- What impact would a simultaneous sell-off in equities and bonds have on an investor's financial position? This might be particularly important for investors making use of leverage.

- What actions can investors take to improve the robustness of portfolios in an environment that poses significant challenges to both equities and bonds?

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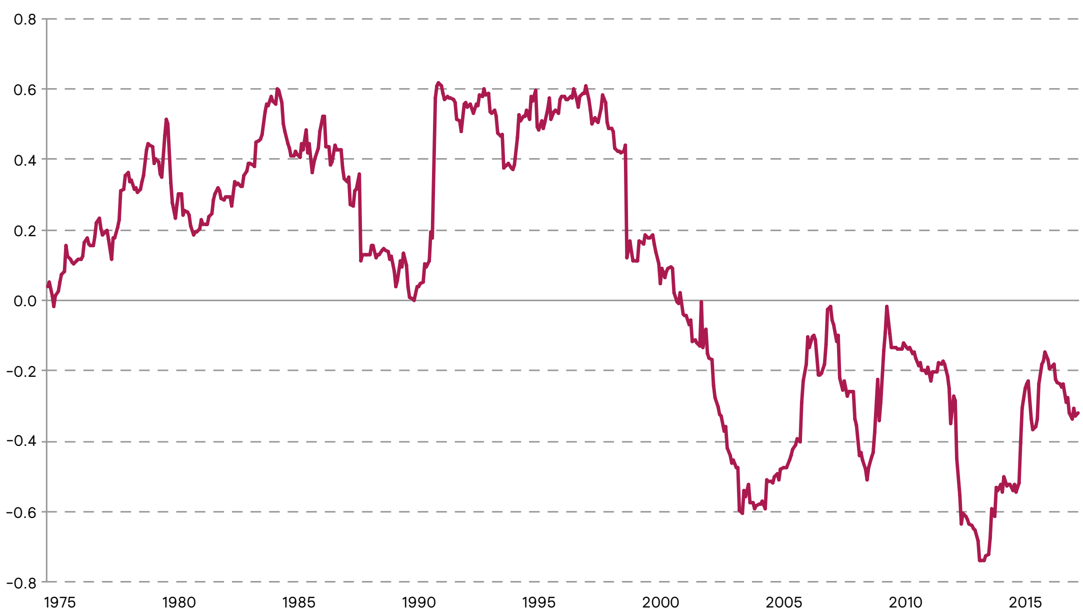
FIGURE 1:
ROLLING THREE-YEAR CORRELATION OF US EQUITIES AND BONDS



Source: Bloomberg

KNOW THYSELF

Before considering what portfolio changes might be appropriate, investors need to have a clear idea of the economic/market outcomes they are least able to tolerate. For example, investors who are sensitive to mark-to-market volatility or who are cashflow negative may be most concerned about large market moves and a dramatic reduction in liquidity over a short space of time. Conversely, long-horizon investors may be most concerned about the erosion of their purchasing power due to an extended period of higher-than-expected inflation.

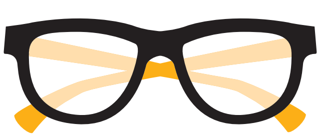
[1] This picture is broadly similar in other major markets.

> Before considering what portfolio changes might be appropriate, investors need to have a clear idea of the economic/market outcomes they are least able to tolerate.

The following questions will help investors narrow down the range of scenarios that are likely to be of most relevance when reviewing investment strategy.

- What time horizon matters most? And will the time horizon shorten during a period of market distress?
- What are the key characteristics of the liabilities (for example, real/nominal, cashflow profile and any flexibility in adjusting cashflow levels in difficult times)?
- What external support might be available, if required, in an unfavorable market outcome (for example, parent company support for a defined benefit pension scheme, other sources of income for a defined contribution investor)? And under what conditions is that external support most likely to be compromised?

Identifying the scenarios of most concern to an investor and then testing the portfolio's likely response under plausible future outcomes are critical steps in the risk management discussion. Investors can then consider what portfolio changes might be justified in light of current market conditions.



SEEK ROBUSTNESS

Building on the previous discussion (which will necessarily be investor-specific), we suggest that investors consider potential actions at three levels:

- **Explicit hedges:** These are defensive exposures designed to provide explicit protection against one or more economic/market outcomes. This category would include government bonds (nominal and inflation-linked), synthetic hedges (such as option strategies and swaps) and tail-risk hedging strategies.[2] Notwithstanding the comments outlined at the start of this article, nominal government bonds will still have a role to play in defending against weakening economic conditions and deflationary environments (especially for investors sensitive to those outcomes). Inflation-linked bonds (where they are issued) will offer some exposure to rising inflation alongside their interest rate exposure, and synthetic hedges can be tailored to meet individual needs.
- **Defensive tilts:** Recognizing the return drag typically associated with explicit hedges, investors should also consider "tilts" (whether in the growth or defensive portfolio) that might improve robustness in scenarios to which the investor is sensitive and potentially exposed. This could include allocations away from equity and/or nominal bonds in favor of defensive hedge funds, senior private debt or real assets with contractual income streams. Low-volatility equity and sub-investment-grade credit might be more defensive than traditional equity exposures, but both are likely to be highly correlated with equities in a crisis (though this will depend to some extent on the nature of the strategy).

[2] Essentially hedge funds that are designed to provide a large positive payoff in stressed market conditions.

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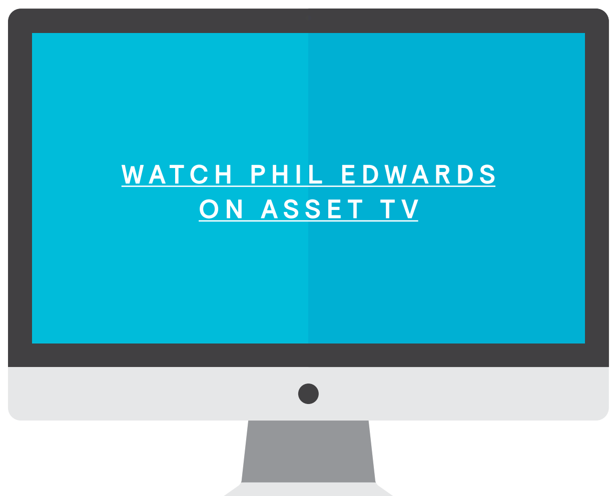
- **Additional flexibility:** High-quality cash may have a role to play in reducing the risk of having to crystallize losses to meet cash outgo or collateral calls in stressed conditions, while also acting as dry powder, offering the ability to redeploy assets at more attractive levels. The latter activity will be available only to investors with a strong governance process and a willingness to act in a dynamic fashion. Investors wishing to delegate this dynamic asset allocation activity might consider idiosyncratic multi-asset strategies.

It is clearly not possible to protect portfolios against all potential scenarios. But investors can identify those scenarios that are most likely to impede the achievement of their objectives and incorporate some degree of protection against those outcomes. In effect, investors should be aiming for a degree of balance in relation to portfolio outcomes under a range of potentially painful scenarios. Robust risk management has never been more important.



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