HIGHLAND

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FOOL'S PARADISE: PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS

On July 15th, Federal Reserve Chairwoman Janet Yellen gave her biannual Humphrey Hawkins testimony to the U.S. House of Representatives. This testimony is an update on the monetary policies utilized by the Federal Reserve ("Fed") and serves as a way of communicating future policies to Congress and market participants. Investors are wary of rising interest rates, so Yellen was very careful choosing her words, using the word "gradual" eight times when describing future interest rate movements. This point of emphasis was designed in hopes that investors would pay more attention to the pace of future rate hikes rather than the date when the hikes will begin.

Many believe that a rate hike will likely signal the end of the road for the secular bull market for bonds. This fear of a bear market for bonds has investors looking for alternatives. We believe that the fear exists because many investors have two main misperceptions of bonds.

BOND MARKET MISPERCEPTION #1: RISING RATES HURT BONDS

The first misperception is that low rates today must signal higher rates in the future, which will be bad for bonds. While this seems like a reasonable assumption, it is the pace at which these higher rates manifest themselves that is critical. For instance, sharply rising rates in the near term will cause price depreciation for bonds. Given today's low starting yields, this could lead to negative total returns for bonds. While this would be a shock to bond investors, higher reinvestment rates would increase expected returns and could end up very positive for bonds' future expectations, especially relative to the current environment. For example, the 10-year U.S. Treasury yield began a secular rise in 1954 that peaked in 1981. The average 10-year return for the Barclay's Capital U.S. Aggregate Index ("BC Agg") during this period (+3.7%) was higher than the 10-year return going into the period (2.6%), illustrating that long-term total returns increased as rates rose.

Another interest rate scenario is that rates take a long time to move higher. This means that bonds will not face a protracted headwind from a price perspective, but there will be a tremendous headwind on the income front. Instead of suffering initial price declines and reinvesting at higher rates, investors will suffer from low yields and depressed income for an extended period of time. Based on our research published in 2011, we continue to believe that this is the more likely scenario (for more info please read Future of U.S. Bond Market and Future of U.S. Bond Market Part 2). In either situation for interest rates, bonds will have trouble satisfying the appetite of investors that are depending on their long-term

OVERVIEW

•With the possibility of a hike in the Fed Funds rate, investors are concerned that the bond market could suffer from interest rates rising.

•While there is risk that interest rates could rise in the short-term, it is possible that yields can stay low for a longer time frame.

•In a rising or flat yield environment, bonds do not offer the same protection against stock market declines as they have over the past 35 years. This means that investors will need to seek alternatives to garner the same level of protection they have experienced in the past.

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historical average return.

BOND MARKET MISPERCEPTION #2: BONDS ARE A CAPITAL APPRECIATION ASSET

The second misperception is that many investors have purchased bonds as a capital appreciation asset, rather than an income asset. Most investors began investing in bonds for income; hence the naming convention "fixed income." But over the past 35 years, investors' perspective of bonds changed. The ample capital gains realized from a long-term bull market in bonds lured investors to price appreciation, thus muting the importance of coupon payments and income investing. While this strategy proved to be lucrative over the past 35 years, future rate environments point to the likelihood that this strategy has run its course.

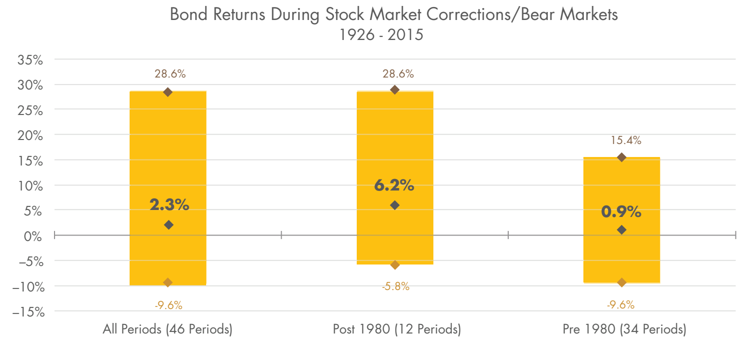
Given today's environment, why should investors hold bonds? While this is a simple question, there is not a single, universal answer. The type of investor usually dictates the reason for investment. A pension fund that is fully funded will hold bonds that closely resemble their liabilities. An endowment will hold bonds to provide income and diversification. We believe an allocation to bonds in a portfolio is essential as a "crisis hedge" that will provide consistency during periods of stock market instability, also known as corrections or bear markets.

BONDS AS A STOCK MARKET HEDGE

Building on the idea that bonds should be held as a "crisis hedge", how have bonds (as measured by the BC Agg) done during difficult stock (as measured by the S&P 500) markets? Yardeni Research studied various stock market environments and concluded that there have been 46 stock market corrections (greater than 10% loss) or bear markets (greater than 20% loss) since 1925. The range of returns (minimum, maximum, and average) for the BC Agg during the periods identified by Yardeni is shown in **Figure 1**. Over the 46 periods, the average return for bonds was +2.3%. The data also shows that the outcome has been drastically different since 1980, as the average returns is 536 basis points or 6.9 times higher than pre-1980.

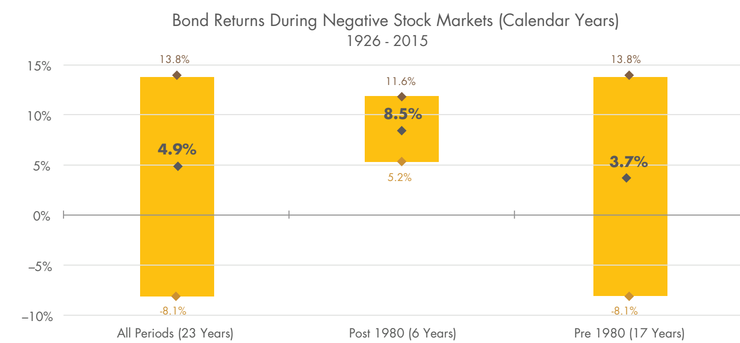
Expanding the analysis to negative calendar years for the stock market supports the initial findings. In the 23 negative calendar years, the bond market has returned +4.9% (see **Figure 2**). Like before, the experience since 1980 is drastically different than pre-1980. It is not just the average that is different, the post-1980 range of outcomes (i.e. maximum and minimum) is much tighter (+11.6% to +5.2%) than pre-1980 (+13.8% to -8.1%).

FIGURE 1



SOURCES: YARDENI; IBBOSTON; BARCLAY'S CAPITAL; S&P; SHILLER; HIGHLAND ASSOCIATES

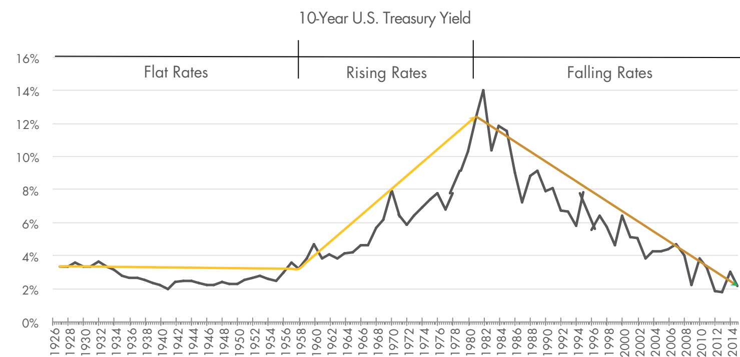
FIGURE 2



SOURCES: IBBOSTON; BARCLAY'S CAPITAL; S&P; SHILLER; HIGHLAND ASSOCIATES

The reason for the dispersion is quite simple. Since 1980, bonds have benefited from a consistent decline in interest rates, driving a long-term secular bull market for bonds (see **Figure 3**). Pre-1980, bonds experienced a long flat rate environment and a persistent rise in rates, neither of which are suitable for above average bond returns.

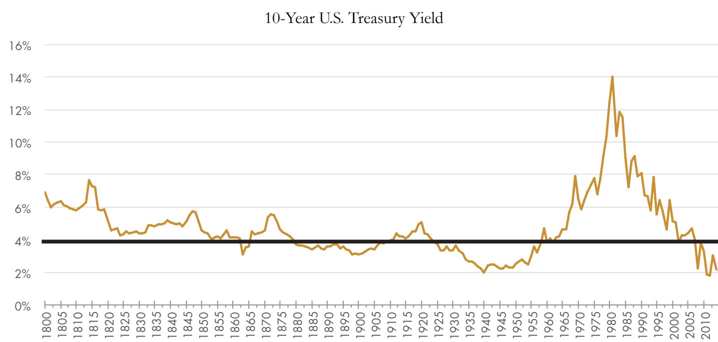
FIGURE 3



SOURCES: U.S. TREASURY; SHILLER; HIGHLAND ASSOCIATES

There have been three distinct interest rate periods since 1925 (see **Figure 3**). The data is a little misleading in that it appears that there are three distinct periods of rates fairly equal in length. By expanding the data set to include pre-1925 data (see **Figure 4**), the true picture of U.S. rates comes into view. The past 35 years has not been the normal pattern and is the anomaly in the full history of data. Specifically, the U.S. 10-Year Treasury yield has been below the 4% level over 63% of the time since 1800 compared to only 23% of the time since 1980.

FIGURE 4



SOURCES: U.S. TREASURY; HOMER AND SYLLA; MACAULAY; SYLLA, WILSON AND JONES; SHILLER; HIGHLAND ASSOCIATES

IMPLICATIONS OF POST 1980 MARKETS

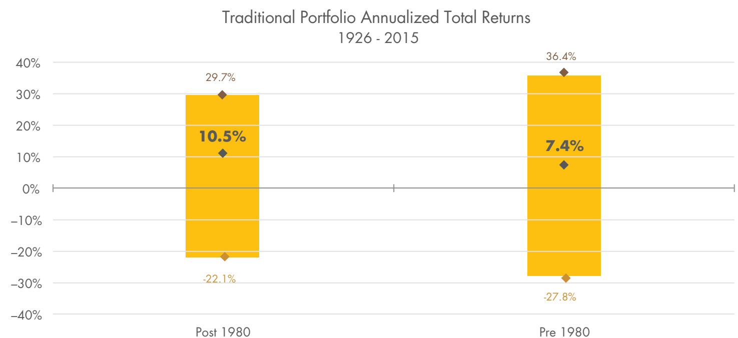
The past 35 years have not only been an outlier for bonds, but it has also framed the present day decision process for many investors. For many that are making decisions on investment portfolios, the bulk of their experience has been in this outlier environment. This overreliance on the more recent history, also known as anchoring, can lead investors to unrealistic assumptions and/or expectations going forward. The advent of the traditional portfolio as a benchmark is one example.

The traditional portfolio was introduced by Harry Markowitz in the 1950s as a way to illustrate efficient portfolio allocations. He concluded that a portfolio consisting of 60% U.S. stocks and 40% U.S. bonds was an "efficient portfolio" and provided diversification. As the investment industry grew in the 1980s and 1990s, this efficient portfolio became popular as a benchmark portfolio.

Many investment alternatives have become available to investors that can provide additional diversification to an investor's portfolio, but anchoring has made it difficult for these strategies to be widely accepted. Hedged equity, real estate, commodities, etc. are all available to investors, but they are not widely held.

Returns for the traditional portfolio are very different pre-1980, with an average return 310 basis points or 31% less than the post-1980 return (see **Figure 5**). The differential between the maximum and minimum also shows that the dispersion of returns pre-1980 was also much higher. In fact, the volatility during the pre-1980 era was 11.6% compared to 9.7% post-1980. Investing prior to 1980 was a much more difficult proposition.

FIGURE 5



SOURCES: IBBOSTON; BARCLAY'S CAPITAL; S&P; SHILLER; HIGHLAND ASSOCIATES

HOW TO PROTECT IN A PRE-1980 WORLD?

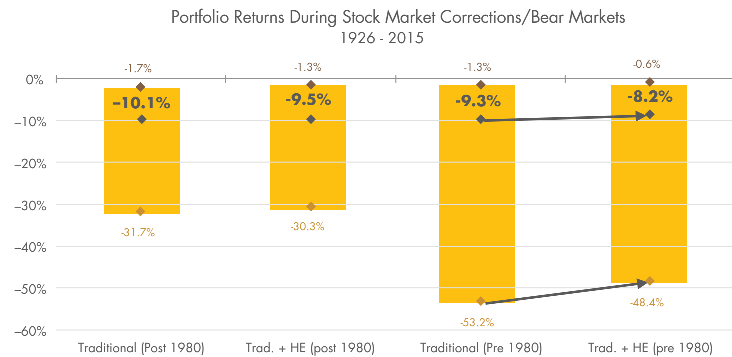
Investors that rely on post-1980 data and expect the same level of protection from fixed income during difficult stock markets are living in a "Fool's Paradise." This is a false sense of reality or delusive contentment, believing that the past 35 years is a baseline for future expectations. Investment professionals are consequently left to answer an important question: Is there a way to protect in the same manner as the traditional portfolio given a new market cycle for fixed income? We believe that the answer to this question is emphatically **YES**. The very same strategies that have struggled to be included in portfolios over the past 35 years (i.e. hedged equity, real estate, commodities, etc.) are the very same strategies that perform well in the pre-1980 environment.

Taking a closer look at hedged equity, can illustrate just how effective alternative asset classes can be for investors. If we take the traditional portfolio and allocate 20% to hedged equity[1], taking an equal amount from stocks and bonds, one can see the benefit of adding an additional asset class. **Figure 6** takes a look at stock market corrections/bear markets and compares the performance of the traditional portfolio to a portfolio that includes hedged

[1] Hedged equity ("HE") is the HFRI Fund Weighted Index from 1990 to 2015. Prior to 1990, hedged equity returns are generated by using the HFRI's historical up/down market capture compared to equities.

equity. This chart really highlights why investors have been reluctant to add hedged equity as a portfolio allocation on a wider scale. Examining the post-1980 return shows that there really has not been much difference between the traditional portfolio and a portfolio with hedged equity. One can easily see that the extra fees, additional due diligence, and decreased liquidity did not provide commensurate results. The pre-1980 return is a much different story. Why is this the case? The answer is bond performance. Bonds during this period did not offer the same outsized positive returns as they did post-1980. Including hedged equity shifts the opportunity set of returns higher, mitigates the downside and enhances upside capture.

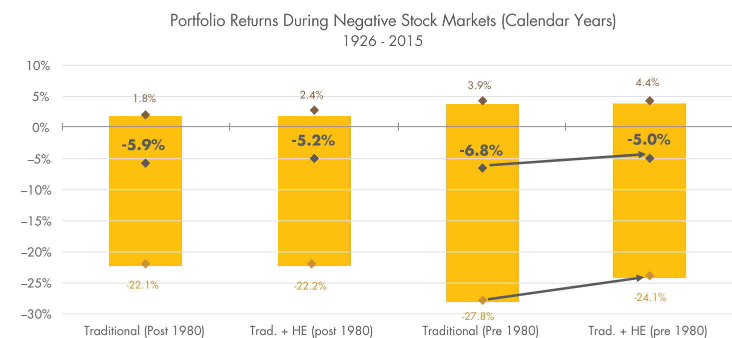
FIGURE 6



SOURCES: YARDENI; IBBOSTON; BARCLAY'S CAPITAL; S&P; SHILLER; HIGHLAND ASSOCIATES

Taking the same analysis as before and expanding the data set to calendar year returns magnifies the benefit (see **Figure 7**). The change is derived from markets experiencing a correction and a subsequent rebound. Hedged equity has the ability to participate more in up-markets than bonds, so the result is a much better calendar year return.

FIGURE 7



SOURCES: IBBOSTON; BARCLAY'S CAPITAL; S&P; SHILLER, HIGHLAND ASSOCIATES

CONCLUSION

Today's environment is one that is wrought with uncertainty. The accommodative policies pursued by central banks created low yields and there is little certitude on the path of interest rates from here. Many investors lack experience in such a landscape and rely on professional experience to extrapolate a proper path for their investment program. What happens when experience does not reconcile with the current environment? For some, hubris can set in as they rely too much on truncated history. This is a recipe for a *Fool's Paradise* that can quickly turn into a *Paradise Lost*. We recognize the limitations of the past 35 years and understand that tomorrow can be very different from recent experience. That is why we seek to understand history and use it as guide for investment, not as a rule. Today that means that bonds do not look like the quintessential stock market hedge they once were, so we are underweight the bond allocation in lieu of hedged equity. Bonds still play an important part as a crisis hedge in portfolios, but reducing their allocation allows for the inclusion of additional asset classes that play a key role in diversifying the portfolio for a shift in market cycle. Highland Associates does not fall victim to the misperception that bonds will provide ongoing capital appreciation, instead we focus on their namesake, fixed ***income***.

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