



Bonds Are Back: Where to Find Value Ahead of Potential Rate Cuts

The fixed income teams at Madison Investments recently published several white papers that discuss how math in the bond markets has dramatically improved for investors. They also highlighted how the intermediate (1-10 year range) part of the yield curve could be the “sweet spot” amid potential interest rate cuts. In this article, we revisit these arguments and introduce additional insights for our readers.

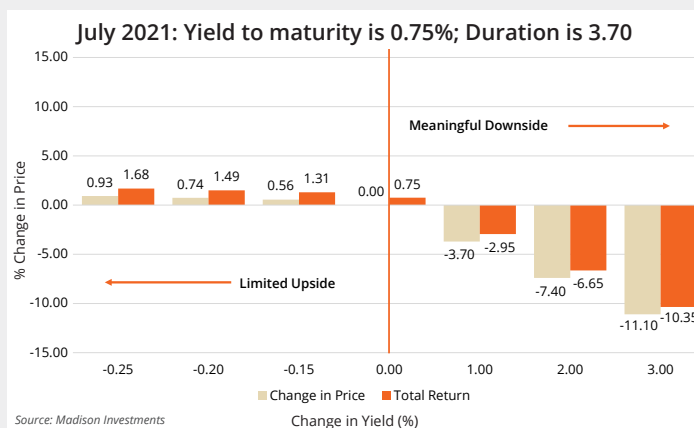
The Case for Bonds

Bond Math Looks Easy

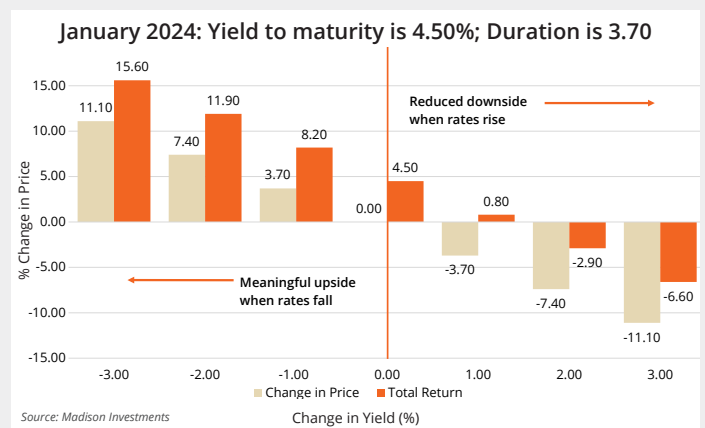
[Published in October of last year](#), near the recent peak in interest rates, we argued that the outlook for bond investors had dramatically improved from just a few short years ago when the Federal Reserve (Fed) was still pursuing its Zero Interest Rate Policy. Back then, a drought of yield available not only robbed investors of any reasonable income on their safe investments but also erased any ability for bonds to act as a hedge against rising rates or falling equity prices. With rates having risen dramatically in the past two years, the “bond math” – from both an income and hedging perspective – is much improved.

Since we published that article last October, intermediate and long-term yields have fallen meaningfully, leaving investors and advisors again asking: do bonds still represent value? We would argue emphatically - yes. Below is an updated version of one of the charts we shared, showing the impact a +/- 1%, 2%, or 3% move in yields would have on total returns. We adjusted the beginning yield on the sample portfolio to 4.50%, reflecting the most recent yield to maturity on the Bloomberg Intermediate Government/Credit Index. The chart still illustrates the significance of a higher starting yield.

Then vs. Now



The low yield environment offered limited upside while still being exposed to meaningful negative returns in a rising rate environment.



Today, bond portfolios offer meaningful upside potential and should act as a hedge against potential equity underperformance. Should rates continue to rise, the higher starting yield will serve as a counter to negative price movements, reducing downside risk.



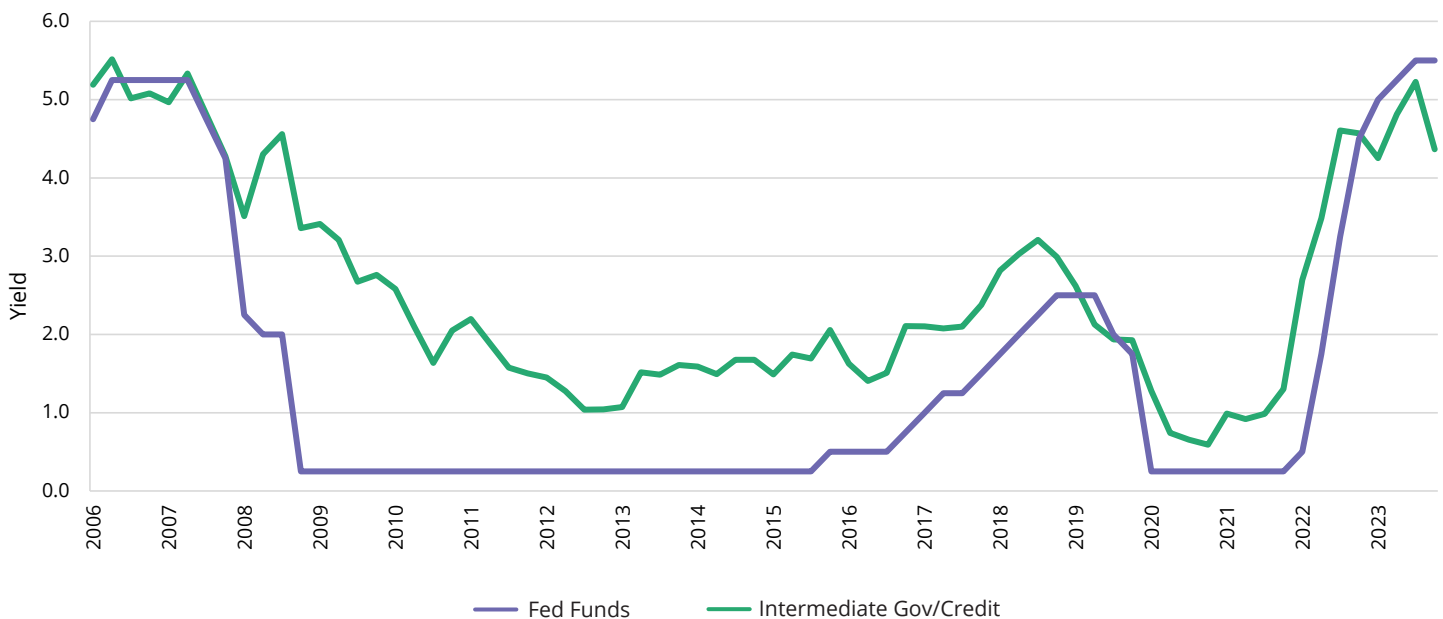
In addition to bond math, there are other ways to illustrate the notable improvement in the outlook for bond investors and the value bonds can offer in an investment strategy. These include absolute, real, and relative yields.

For illustration purposes, we use the Bloomberg Intermediate Government/Credit Index as a proxy for the intermediate maturity bond market and the Fed Funds rate as a stand-in for the yield available in cash and other very short-term investments.

ABSOLUTE YIELDS

As the charts below show, absolute yields available in short and intermediate-term bonds have not been this attractive since just before the Great Financial Crisis. In fact, from late 2007 until mid-2022, with a very short exception in 2017-2018 when the Fed was initially attempting to normalize rates, money market funds yielded near zero, and a high-quality, intermediate bond portfolio struggled to provide an annual income of even 1.5-2%. Today, an investor can comfortably achieve a yield several times greater than what was available for most of the past 15+ years.

Intermediate Gov/Credit vs. Fed Funds



REAL YIELDS

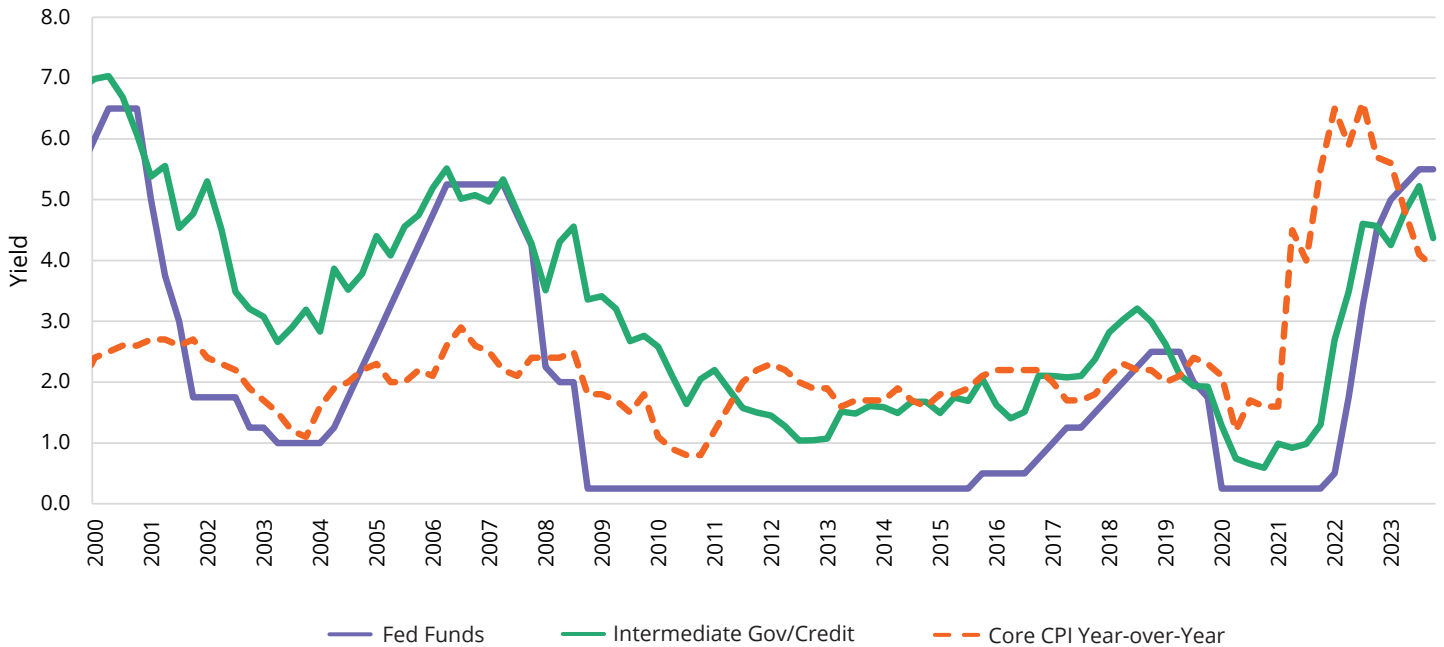
Any amount of yield is not truly valuable if it cannot provide a return greater than the inflation rate. The difference is known as a "real yield." Real yields are positive when the yield on a portfolio is greater than inflation and negative when the portfolio yield is below inflation. Before the Great Financial Crisis and the introduction of quantitative easing, short-term bonds typically provided a positive real return, but not always, as the Fed used short-term rates to implement monetary policy. Intermediate-term bonds, on the other hand, offered investors a reliable source of return that consistently outpaced inflation.



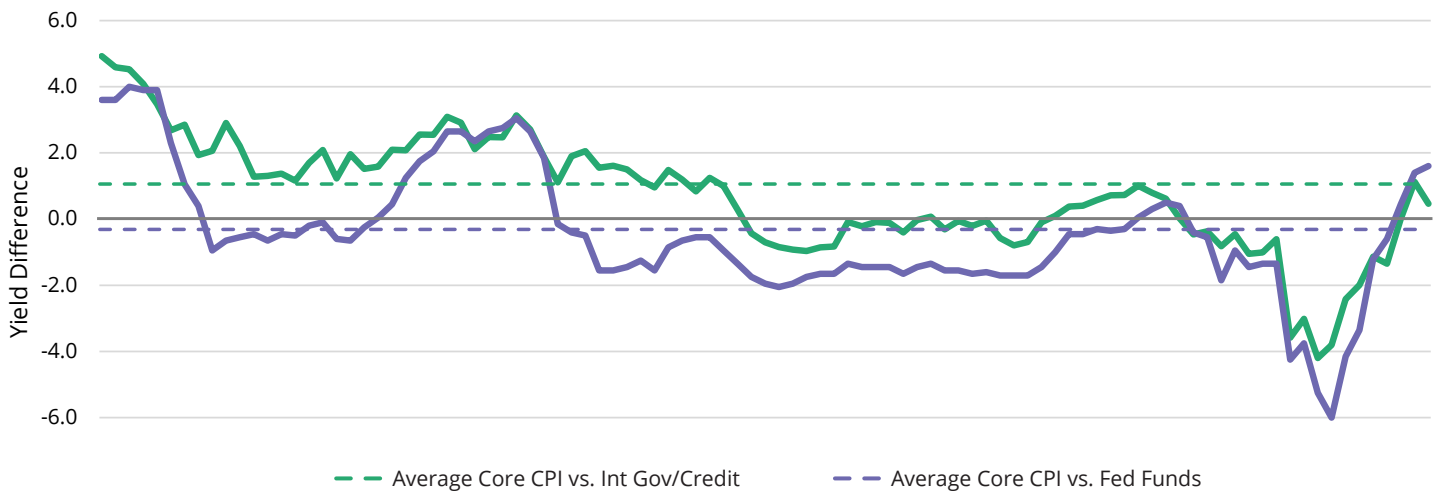
REAL YIELDS (continued)

That changed with the Fed’s historic easing and the introduction of quantitative easing after the Great Financial Crisis. For most of the next 15 years, cash and money market funds offered negative real yields, while intermediate bonds struggled to break even with inflation. With rates back to historically normal levels, this has also changed. Short and intermediate real yields are once again positive, and those real yields should improve if inflation continues to moderate.

Core CPI vs. Fed Funds and Intermediate Gov/Credit



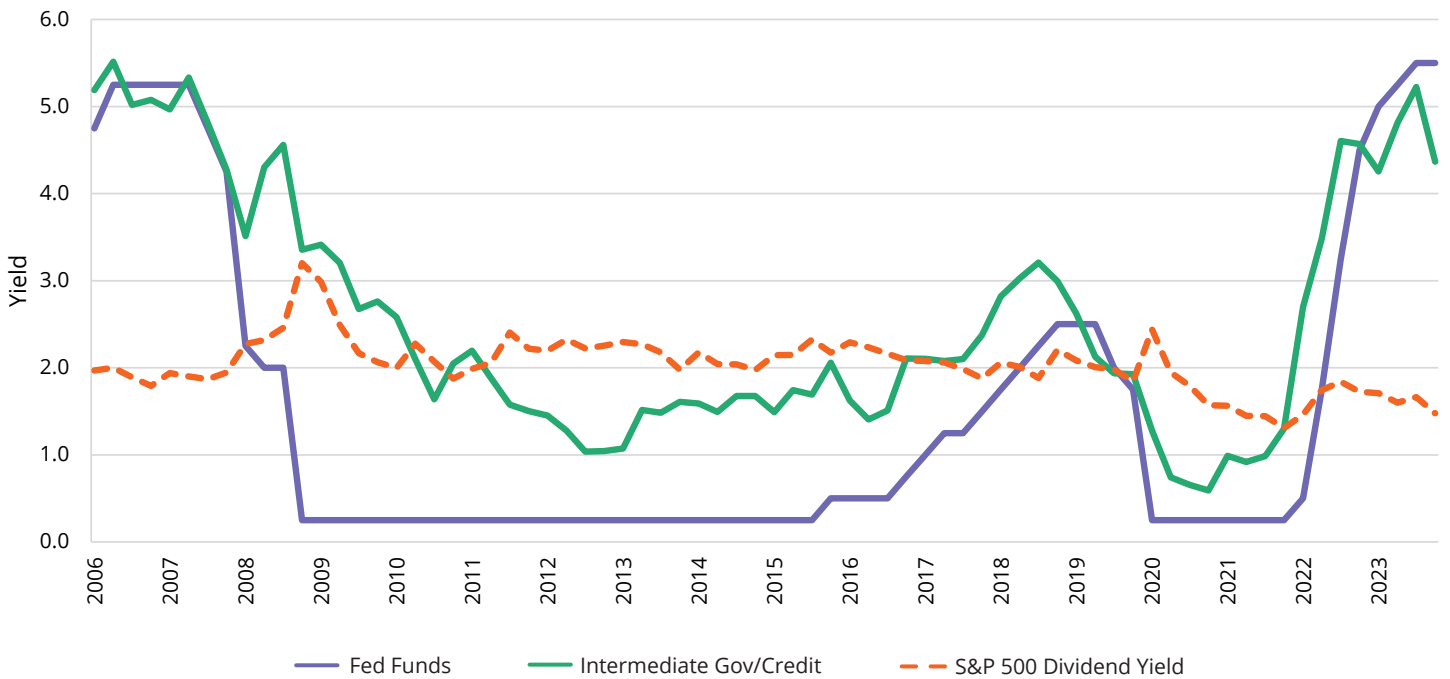
Difference



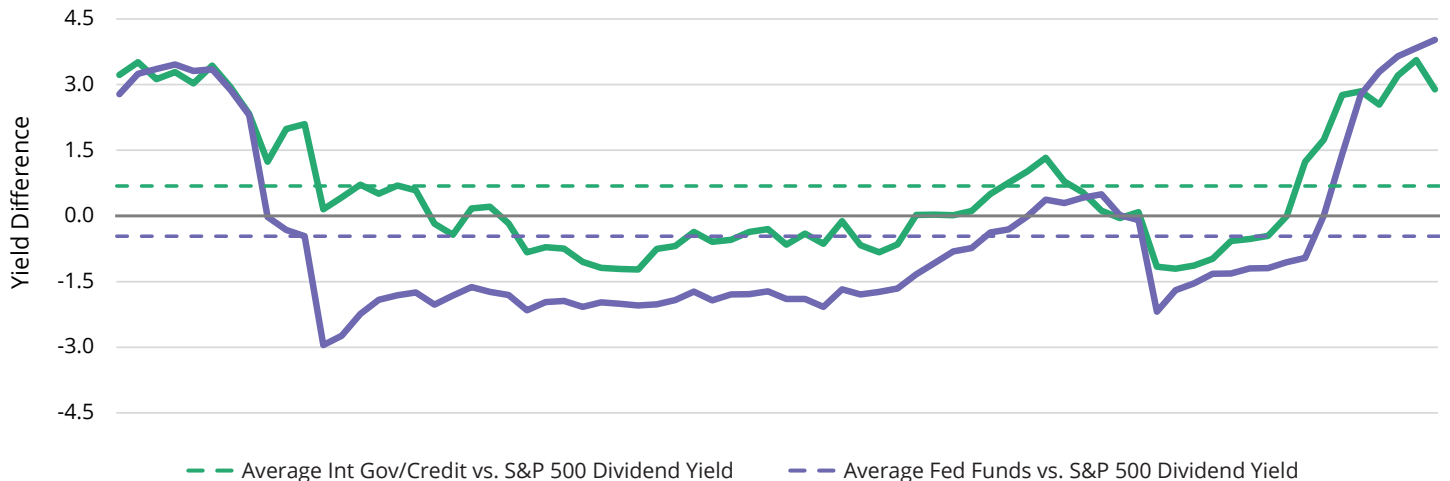
RELATIVE YIELDS

Another way to see the current attractiveness of bonds involves comparing their yield to maturity to the dividend yield available in dividend-paying stocks. Traditionally, many investors consider bonds attractive when they provide a yield greater than that available in high-quality, dividend-paying stocks. By that measure, bonds suffered relative to stocks for many years. However, with substantially higher absolute and inflation-adjusted yields available in today's bond market and a rising-priced stock market that has depressed dividend yields, bond yields have become as attractive relative to stock dividends as they have been since, you guessed it, before the Great Financial Crisis.

Intermediate Gov/Credit and Fed Funds vs. S&P 500 Dividend Yield



Difference

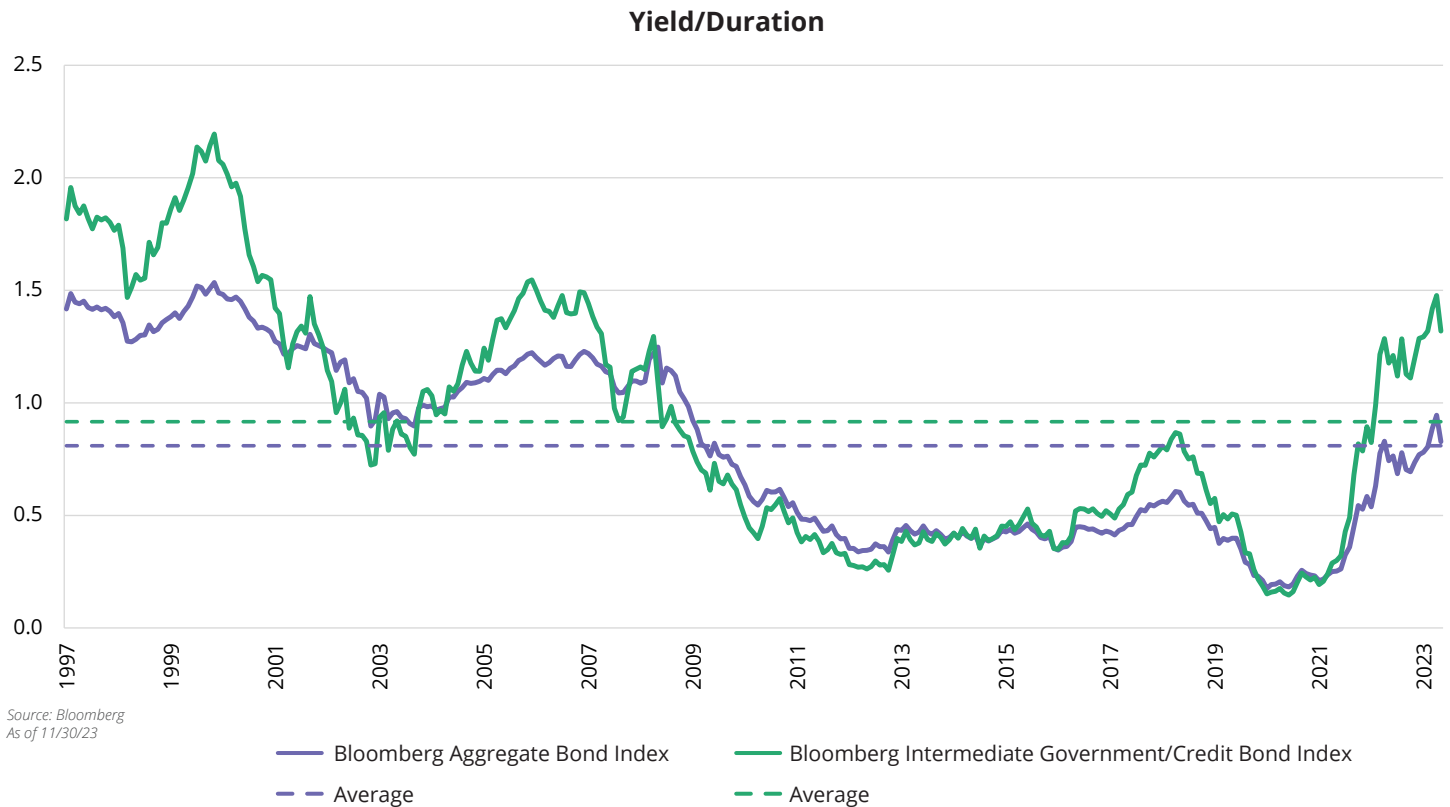


Which Bonds to Target Duration per unit of risk

In another white paper we released early this year, [“Why Accept More Risk for Comparable Yield?”](#), we argue that intermediate bonds offer greater value than longer-term bonds, at least from an interest rate risk standpoint. A way to measure this is yield per unit of duration. This concept is similar to the Sharpe or Information Ratio often used in the equity markets.

To illustrate this point, we use the Bloomberg Intermediate Government/Credit Index as a proxy of an investment grade portfolio of intermediate bonds and the Bloomberg Aggregate Index to represent a longer maturity option.

The chart below shows that while yield per unit of duration is much improved for both intermediate and longer-term bonds, intermediate bonds appear far more attractive on an interest rate risk-adjusted basis.



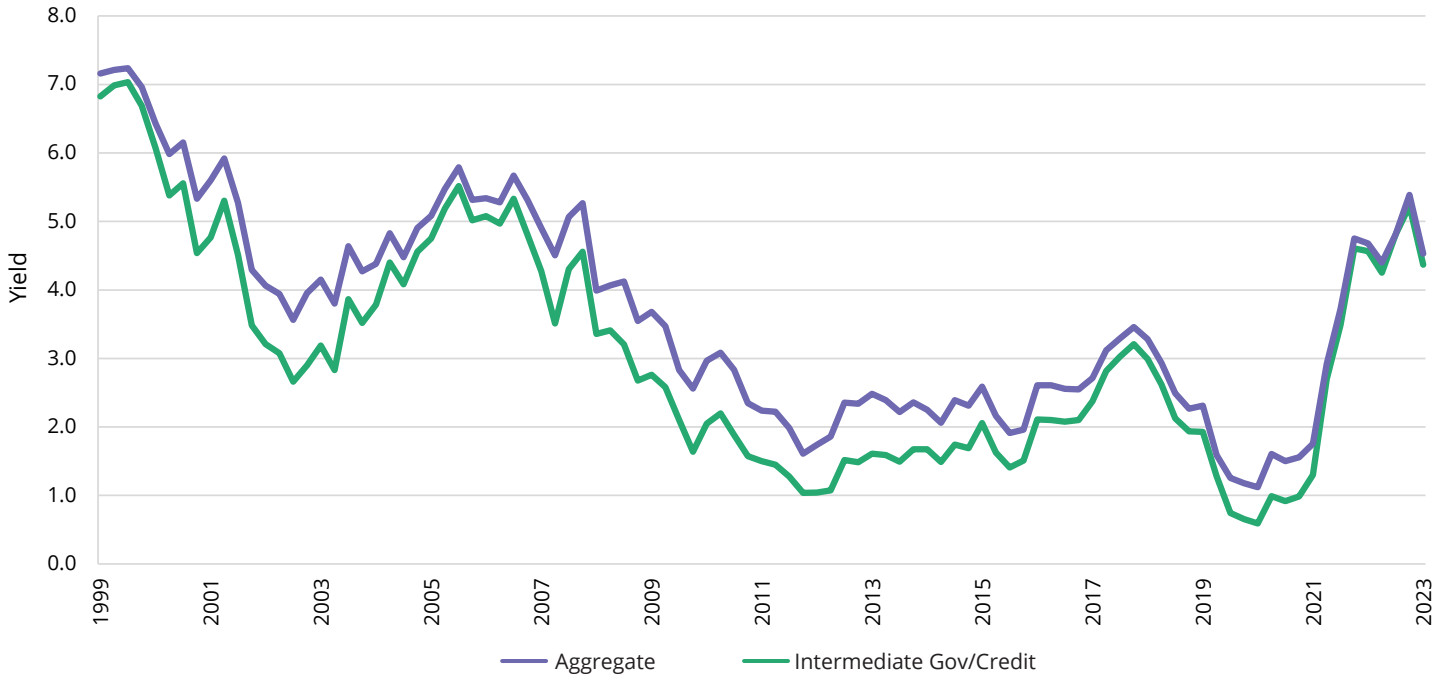
We then pointed out that, perhaps counterintuitively, intermediate maturity portfolios tend to perform quite well relative to longer maturity portfolios during Fed easing (falling rate) cycles. We showed that, except for the COVID easing of 2020, intermediate bonds either held their own or outperformed throughout each of the previous five easing cycles. Our reasoning was that yield curves rarely move in parallel. In most easing cycles, the Fed dramatically lowers short-term rates, and often, longer-term rates fall much less. The result is a very steep yield curve. So, while all rates may fall in easing cycles, short and intermediate bonds benefit more as their yields are more impacted by the steepening curve. It's not just how much duration you own but where you own it.



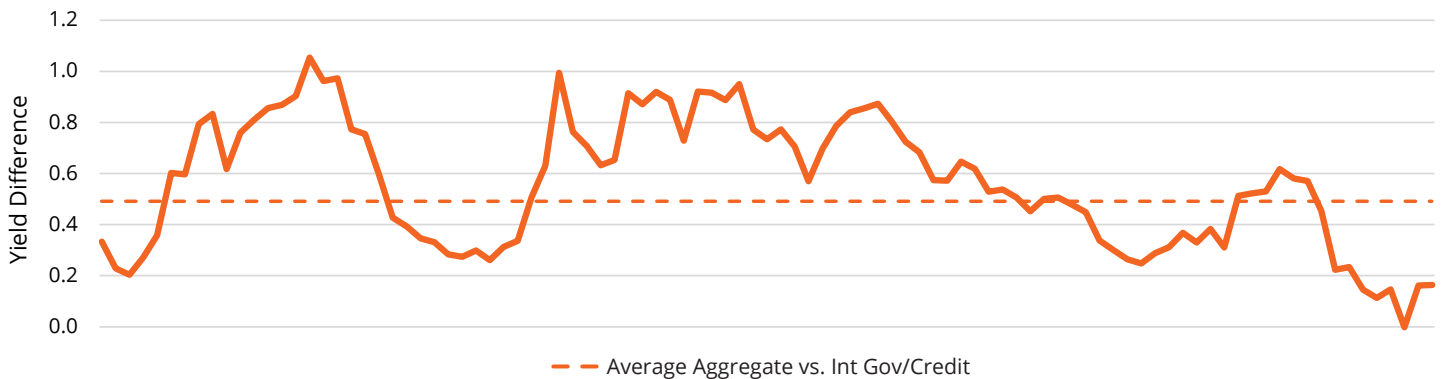
ABSOLUTE SPREAD

It seems logical that the absolute reward for taking additional risk should impact the decision on how much risk to take. As the charts below show, for most of the past quarter century, the average yield reward for moving from an intermediate to a broad market strategy has traditionally been a bit over one-half percent (0.5%); today, that difference is near historically low levels. This prompts a fundamental question: why accept more risk for seemingly comparable yields?

Aggregate vs. Intermediate Gov/Credit



Difference



CONTRIBUTING FACTORS – SPREAD RISKS: CREDIT, STRUCTURE, AND LIQUIDITY RISK

A contributing factor to our thesis above is the role risks other than interest rate risk play in explaining relative performance between intermediate and longer-term bond portfolios in various market environments. The total risk of a portfolio is a function of not only interest rate risk, often measured by duration, but also what is called spread risk, which is made up of credit, structure, and liquidity risk.



Many intermediate-maturity bond portfolios are benchmarked to a 1-10 year intermediate government/credit index, the Bloomberg Intermediate Government/Credit Index being the most popular. Most longer maturity portfolios are benchmarked to a 1-30 year broad market index, and the Bloomberg Aggregate Bond Index is used most often. Benchmarks generally define the pool of assets available to a bond manager and what percentage of that universe each asset class within it represents. And here, like duration, the differences are meaningful.

While the Aggregate Bond Index has approximately 68% more duration (interest rate risk) than the Intermediate Index (6.2 vs 3.7 duration), the additional exposure to spread risk is just as dramatic. In bonds, spread risk is not simply a function of how much of something you own but also the average maturity or duration of that exposure. The longer the maturity and duration, the more you are exposed to changes in spreads.

The table shows the exposure to each of the spread sectors as a percentage of the total benchmark and the average duration of each of those exposures.

Not only does the Aggregate Bond Index have more exposure to the spread sectors (53.36% vs. 30.79%), primarily due to the introduction of the mortgage markets (this is where the structure or prepayment risk comes in), but the duration of those exposures is much longer (6.43 vs. 3.97).

	Bloomberg Intermediate Gov/Credit Bond		Bloomberg Aggregate Bond	
	% Held	Avg. Duration	% Held	Avg. Duration
Utility Bonds	2.05	4.45	2.18	8.77
Industrial Bonds	15.97	4.03	14.60	7.80
Financial Bonds	12.77	3.81	8.26	5.31
Mortgage Backed Securities (MBS)	0.00		26.66	5.97
Commercial MBS	0.00		1.66	4.33
Total	30.79	3.97	53.36	6.43

As of 12/31/23

Why does this matter? Generally, interest rate and spread risk are relatively uncorrelated. If the economy is doing well, spread risk is being rewarded as spreads on risk assets shrink, but rates tend to be increasing. Conversely, when the economy is doing poorly, spreads widen, but rates fall. This helps explain why an intermediate portfolio, with much lower exposures to both interest rate and spread risk can be a good, less volatile alternative to a longer maturity structure, especially when the yield differences between the two are minimal.

Conclusion

As we have outlined in this and previous articles, the return of yield has presented investors with one of the better opportunities of the past 20 years to invest in fixed income. Given the risk dynamics within the bond market and historical yield curve trends, we argue that the intermediate maturity portion of the bond market offers a superior risk/reward profile compared with longer maturity alternatives.

This is not to say that longer, Aggregate-like portfolios are an inappropriate investment. Many investors want or need that longer duration exposure - think of life insurance companies, pension plans, or investors with very long investment horizons. In fact, the Madison Fixed Income teams offer a number of portfolios benchmarked to broad market indices. But for many investors looking for traditional exposure to the domestic bond markets, we believe now is a good time to invest, and intermediate-maturity bonds have the greatest risk-adjusted potential.



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INDEX DEFINITIONS

Indices are unmanaged. An investor cannot directly invest in an index. They are shown for illustrative purposes only, and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

S&P 500® is an unmanaged index of large companies and is widely regarded as a standard for measuring large-cap and mid-cap U.S. stock-market performance. Results assume the reinvestment of all capital gain and dividend distributions. An investment cannot be made directly into an index.

Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage backed securities, asset-backed securities and corporate securities, with maturities greater than one year.

DEFINITIONS

Yield to Maturity: the rate of return on a bond calculated on the basis of purchase price, redemption price, the total interest payments, and the number of months or years until maturity. The yield to maturity is greater than the current yield when the bond is selling at a discount, and less when the bond is at premium.

Yield Curve: a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity. There are three main types of yield curve shapes: normal (upward-sloping curve), inverted (downward-sloping curve), and flat. Yield curve strategies involve positioning a portfolio to capitalize on expected changes.

This report is for informational purposes only and is not intended as an offer or solicitation with respect to the purchase or sale of any security.

In addition to the ongoing market risk applicable to portfolio securities, bonds are subject to interest rate risk, credit risk and inflation risk. When interest rates rise, bond prices fall; generally, the longer a bond's maturity, the more sensitive it is to this risk. Credit risk is the possibility that the issuer of a security will be unable to make interest payments and repay the principal on its debt. Bonds may also be subject to call risk, which allows the issuer to retain the right to redeem the debt, fully or partially, before the scheduled maturity date. Proceeds from sales prior to maturity may be more or less than originally invested due to changes in market conditions or changes in the credit quality of the issuer.

Bloomberg U.S. Intermediate Government/Credit Bond Index measures the performance of United States dollar-denominated United States Treasuries, government-related and investment-grade United States corporate securities that have a remaining maturity of greater than or equal to one year and less than 10 years.

Duration: a measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates. Duration measures how long it takes, in years, for an investor to be repaid the bond's price by the bond's total cash flows.

Bond Spread: the difference between yields on differing debt instruments of varying maturities, credit ratings, and risk, calculated by deducting the yield of one instrument from another.

