



INVESTMENT INSIGHTS

Analysis, Insights, and a Different Perspective

September 2024

KEY POINTS

- Despite recent downturns in 2021 and 2022, bonds continue to play an important stabilizing role in portfolios, offering resilience during stock market volatility and fewer overall negative years compared to stocks.
- Historical data shows that bonds generally maintain steady returns regardless of stock market fluctuations, with similar performance in both up and down stock markets, underscoring their reliability as a long-term investment.
- While essential for diversification, bonds come with their own risks, such as interest rate sensitivity and potential default, which require careful consideration within an overall financial strategy.

THE ROLE OF BONDS IN DIVERSE PORTFOLIOS

Although the bond market was up in 2023, returns were negative in 2021 and 2022 – the first time bond investors have ever experienced consecutive years of negative returns. After double down years, some people had concerns about the role of bonds in a portfolio, but we believe these concerns are overstated. Bonds continue to serve a crucial role in investors' portfolios, as we will demonstrate in this month's newsletter.

When discussing bonds, the typical starting point is their correlation with other assets like stocks. However, this measure can be overly complex and not intuitive, especially as it varies over time. Instead, we will examine the long-term returns of asset classes with a straightforward approach that aims to make bond returns easier for investors to understand. While this approach may lack some mathematical rigor (like using correlations and standard deviations), we still believe that this historical perspective tells a compelling story.

LONG-TERM PERFORMANCE

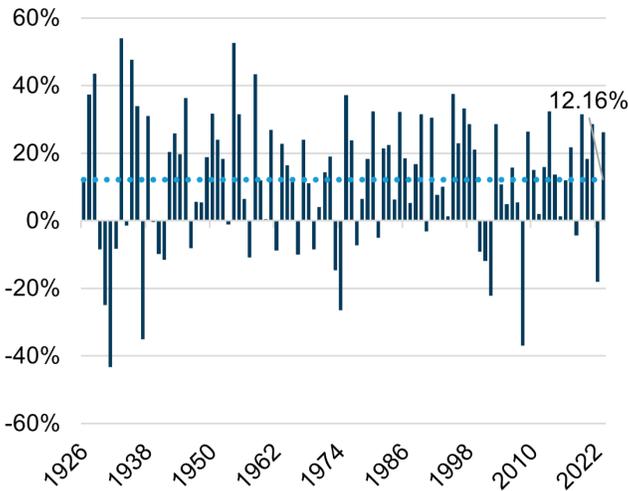
Using the long-term data, we start by looking at calendar year returns for stocks and bonds. We use the S&P 500 to represent stocks and the five-year U.S. Treasury to represent bonds. As you can see in the graph below, stocks have had higher returns historically, but these returns have also been more volatile. Stocks have declined more than 20% six times and more than 10% 12 times over this entire 98-year period. A similar pattern emerges when looking at the past 50 years. Since 1974, stocks than 20% three times and more than 10% five times.



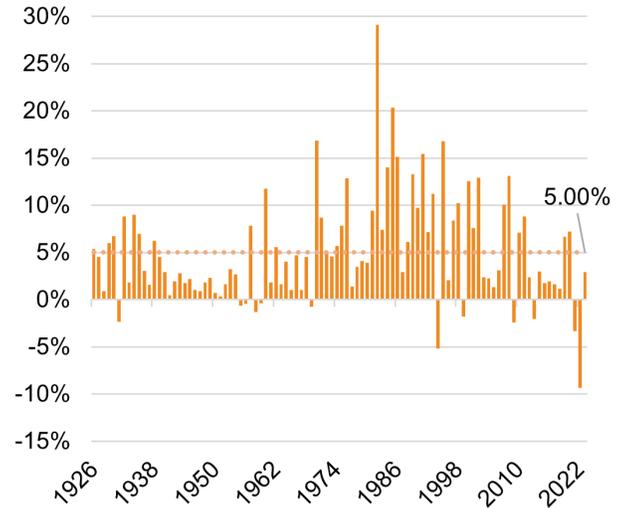
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Therefore, investors have experienced a 20% decline in their stocks once every 16 years and a 10% decline in their stocks every 10 years on average. Bonds, on the other hand, have not dropped by more than 10% during any year since 1926. Bonds, in fact, were negative for the entire year less often than stocks. Since 1926, they were down roughly 12.24% of the time compared with stocks, which were negative more than twice as much at roughly 27% of the time. This resilience underscores their importance as a diversifying element to help smooth out investment returns during turbulent market periods.

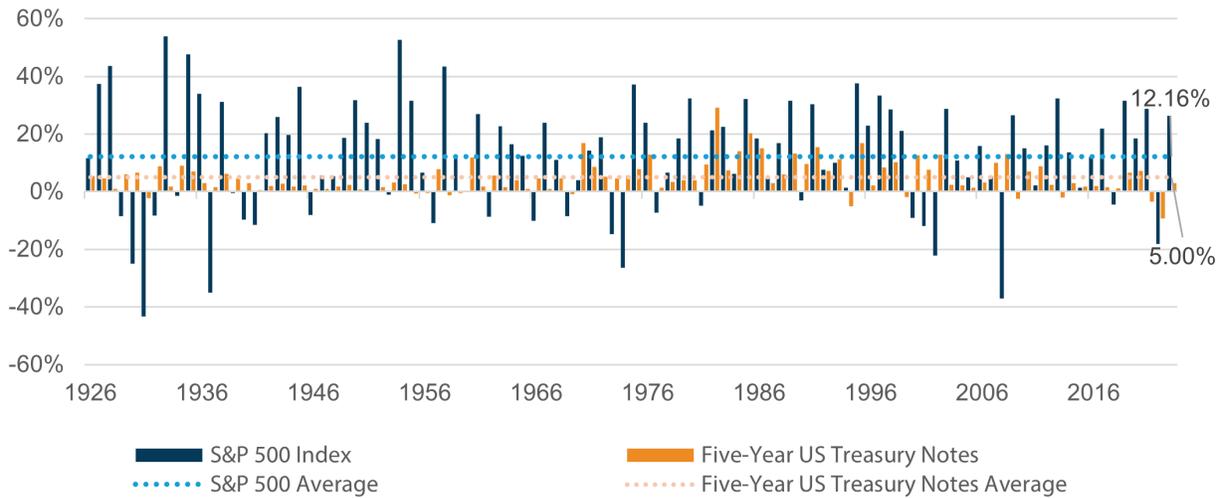
YEARLY RETURNS FOR S&P 500 (1926-2023)



FIVE-YEAR U.S. TREASURY NOTES (1926-2023)



S&P 500 AND FIVE-YEAR U.S. TREASURY NOTES (1926-2023)



Data Source: DFA

PERFORMANCE IN DIFFERENT MARKETS

Note that in the chart above, the average return of bonds for all years has been approximately 5.00%.¹ How do returns change based on stock market developments? As we will see, not much.

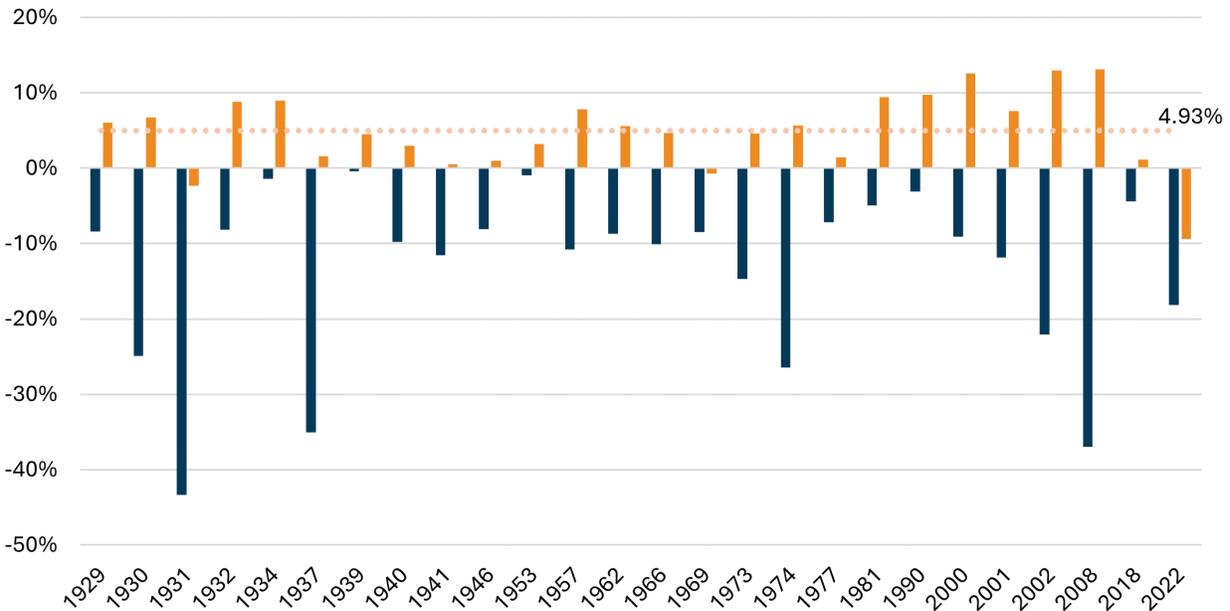
The first graph on pg. 3 shows the stock and bond returns for years when stocks were down. The average return for bonds during these years is similar to the average of all years at approximately 4.93%. The proportion of years that

¹ While a geometric average would be more accurate, for simplicity, we use the arithmetic average.

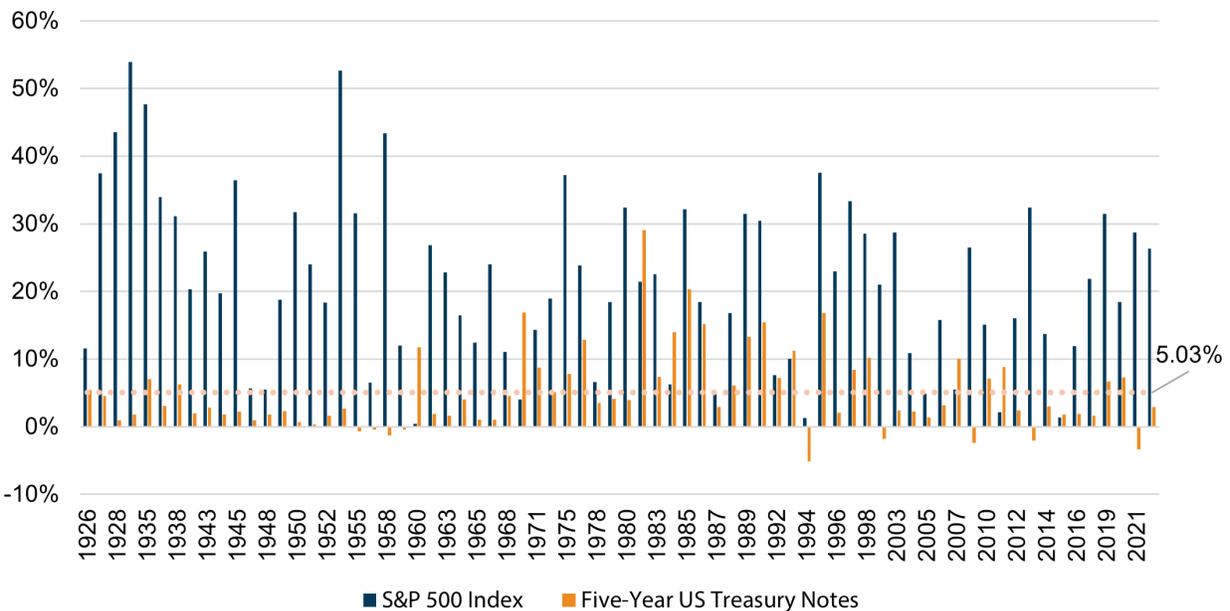
bonds are down when stocks are down also does not change much compared with all years at 11.54% vs. 12.24%. So, when stock markets are down, the performance of bond markets does not deviate much from the overall average.

Next, let's look at bond returns when stocks have a positive gain for the year. In the second graph below, the average return for bonds during years when stocks are positive is also close to the average of all years at approximately 5.03%. The percentage of years when bonds are down when stocks are up is also similar at 12.5% vs. 12.24% for all years. Therefore, historically, bond returns are also similar to their long-run average when stocks are up.

FIVE-YEAR U.S. TREASURY NOTES DURING NEGATIVE S&P 500 INDEX YEARS



FIVE-YEAR U.S. TREASURY NOTES DURING POSITIVE S&P 500 INDEX YEARS



Data Source: DFA

One reason investors choose to invest in bonds is to dampen the effects of stock market volatility on their portfolio, often referencing the belief that, when stocks decline, bonds “typically” do well. Many investors, however, experienced negative returns in both their stocks and bonds in 2022. The odds of bonds and stocks being down in the same year have historically been low. In fact, in the past 98 years, this has happened only three times (1931, 1969, 2022).

A different framework for the decision to invest in bonds may serve investors well. While it is not necessarily the case that bonds perform well when stocks decline, bonds can act as a calming feature on a portfolio because:

- They are less volatile than stocks.
- On average, they have had fewer negative years than stocks. Historically, bonds have had negative returns less than half as often as stocks.
- Bond returns are similar regardless of stock market performance.

Investors should note that the future may look different from the past. Using historical data as a guide for the minimum level of volatility we are likely to experience going forward may help investors avoid making conclusions based on short-term trends.

YOUR PLAN

Bonds play an important role, but they are not without risks. Rising interest rates can lower bond returns if they are not held to maturity, and non-government bonds may also carry a default risk. Investors should evaluate these risks in the context of their overall financial plan, which your advisor can help you put together.



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