Strategic Asset Allocation and the Paradox of Bond Investing

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Fixed income funds have many important functions in global capital markets. Life insurance companies may buy long-term bonds to hedge long-term life insurance policies. Commercial insurance companies may purchase intermediate-term bonds to hedge various shorter-term liabilities. Pension funds may buy various maturity bond funds to match vested retirement liabilities. Central banks may use various maturity fixed income funds to manage macroeconomic risks.

However, the role of bond investing for investors with long-term strategic goals is arguably controversial. This is because, on average, bonds underperform stocks. Historically stocks outperform bonds roughly 70% of the time and there are few non-overlapping five year periods in American financial history where bonds have outperformed stocks. Therefore, why not ignore bonds and invest solely in equities? As importantly, why is the performance of large generic bond funds appropriate as a low risk return benchmark for strategic investing?

The paradox of bond investing in strategic asset allocation has a simple explanation and interesting implications. In an optimized asset allocation, the role of the fixed income fund is not to add return relative to risk as a standalone asset but to optimally hedge overall portfolio risk at each point of the efficient frontier. As a result the risk characteristics and performance of the component fixed income portfolio will generally deviate significantly from generic bond indices. Fixed income investing in a strategic asset allocation should be defined within an optimized portfolio context and does not depend on whether or not bonds outperform stocks on average over time. The interesting implication is that traditional comparisons between the fixed income component of an optimized strategic portfolio and generic fixed income funds are generally invalid.

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