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A reprinted article from September/October 2021

Considering All Options for Bonds: Challenges to the 40 Percent of the 60/40

By Benjamin Doty, CFA®, W. J. Rossi, CFP®, ChFC, and Chandler Norder

INVESTMENTS & WEALTH INSTITUTE®

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CHALLENGES TO THE 40 PERCENT OF THE 60/40

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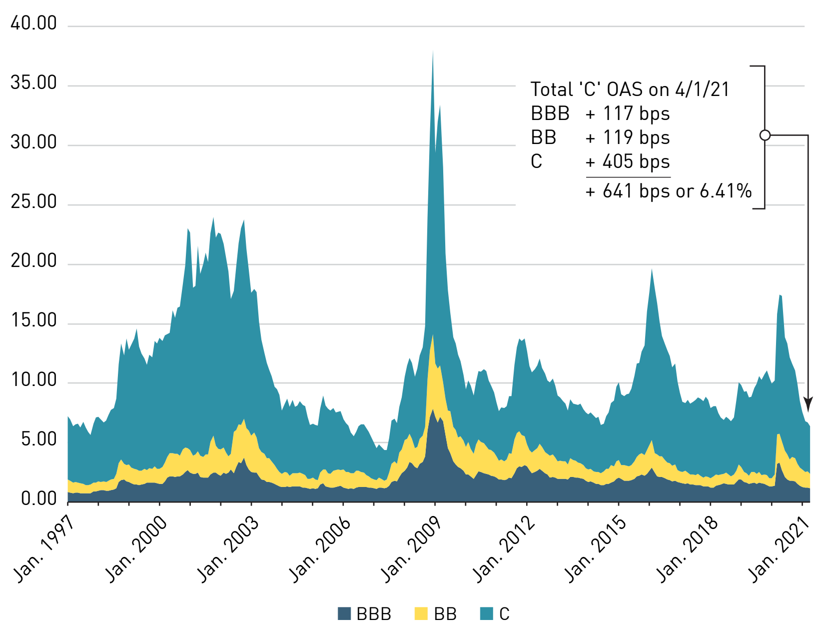
Low rates, seemingly stretched valuations, and unprecedented monetary and fiscal stimulus have made for a unique set of investment challenges and opportunities in 2021. As has been the case for several years, circles are still debating the efficacy of the traditional 60-percent stocks/40-percent bonds mix that has permeated most balanced portfolio solutions for decades. Some have questioned its very foundation, especially its ability to generate sustainable withdrawal rates. This article seeks to address the most challenging part of the foundation—the purpose of bonds to provide income and capital preservation.

At best, we hope to leave you with an idea you have not considered. At worst, we will have given you a point of comparison when addressing this problem. We hope it helps you to check every box.

Figure 1

OPTION-ADJUSTED SPREAD (OAS) STACKS



BOND RATES: LOOKING FORWARD

Many concerns about the demise of the 60/40 balanced portfolio stem from the obvious conclusions drawn from the 40-year descent of Treasury rates, the so-called bull market in bonds of similar length. The worry now is that these rates, particularly at the intermediate and long end of the yield curve, will rise. Since 1962, the 10-year (constant maturity) U.S. Treasury rate has averaged 6 percent. A rise of 400 basis points, closer to the long-term average, would imply a loss of about 36 percent, i.e., a duration of nine years multiplied by the rise, a sizeable loss even if stretched over 10 years. No wonder the concern.

Despite the headline fears of inflation, we believe that we will not see long-term rates attain that past average. We see a long-term trend toward the 10-year average of 2.2 percent. At worst, the 10-year U.S. Treasury rate could approach the average level seen over the past 30 years of 4.25 percent or, somewhere in between, such as the 3.2 percent of the past 20 years.

We can expect the pattern to mirror that of Japan. Since 1995, the Bank of Japan has not been able to reflate the economy and see its 10-year government rate rise above 3 percent. U.S. real gross domestic product growth and low inflation will act to normalize the 10-year U.S. Treasury rate over the long term, based merely on the time value of money concept; i.e., a country should pay back what it borrows at the rate that capital can grow, which is how much it can grow its national income. At the same time, economic dynamics likely will result in somewhat better outcomes for the United States than for Japan.

In addition, corporate bond spreads, although tighter in some subsectors than others, are also likely to tend toward a level of normalization. Option-adjusted spreads on corporate bonds rated BBB are about 117 basis points as of the beginning of April 2021, below the 178-basis-point median since 1997. Normalization on the lowest rung of the investment-grade scale is less than 100 basis points away. Stacked up, the compensation for credit risk, although

Table 1

U.S. HIGH-YIELD AND INVESTMENT-GRADE DOWNSIDE CHARACTERISTICS WITH A MOVING STRATEGY (NOVEMBER 1987–MARCH 2021)

Fund	Compound Annual Growth Rate	Standard Deviation	Worst Year	Maximum Drawdown	Sharpe Ratio	Market Correlation
Vanguard High Yield Corporate Investors (VWEHX)	7.33%	7.05%	−21.29%	−28.90%	0.62	0.64
Vanguard Total Bond Market Index Investors (VBMFX)	5.94%	2.72%	−3.64%	−5.05%	0.79	0.09
Moving Average Strategy	8.36%	5.02%	−1.34%	−7.01%	1.02	0.50

Source: Portfolio Visualizer

not fantastic, is not outside recent historical norms, relative to any elevated risks (see figure 1).

We also recognize that just as stocks get dramatically reset in terms of valuations in a bear market, so do any fixed income assets with credit risk. Prospects can get very attractive and very dim in short amounts of time. A correction can quickly reset the credit curve to a more reasonable normal.

ADDRESSING THE ISSUE

We have taken a multi-prong approach to address the challenges of lower returns from the stock/bond income mix. We have:

1. Lowered our long-term return expectations across our portfolio combinations.
2. Considered stepping up equity allocations where necessary to meet concerns and goals.
3. Introduced alternatives, such as commodities, especially if there is non-transitory inflation.
4. Introduced momentum rules to take more bond risk while protecting against drawdowns.
5. Considered covered calls and high-dividend stocks with and without spread strategies in limited cases to generate income.

Because the first three approaches are clear cut, we will focus on explaining the benefits of the fourth and fifth approaches.

TREND-FOLLOWING

Trading on technical or following trends has long been applied to the stock market but has been less utilized in the context of fixed income investments. Yet, as bond investors reach for yield in riskier investments and large drawdowns have a bigger impact on credit-sensitive instruments (and stocks) with lower expected returns, it's appropriate to reconsider these options. In the past, our firm has traded on simple 200-day trend-following strategies, particularly in higher volatility investments such as natural resources and emerging-market equities.

Now may be a time to see how trend-following, for example, can help manage higher risk bond portfolios. For the purposes of illustration, we focus on high-yield U.S. corporate bonds, which tend to have almost two-thirds the volatility of equities. The platform for the comparison will be Portfolio Visualizer,[1] and the trend-following strategy is a 10-month moving average, which closely approximates a 200-day rule. Although this strategy is best implemented with exchange-traded funds (ETFs), we use the Vanguard High Yield Corporate Investor Bond Fund (VWEXH) and Vanguard Total Bond Market Index Investor Bond Fund (VMBFX), because we can start the analysis from as far back as 1987 (see table 1).

Use of the moving average with the high-yield fund results in an improvement in all downside-risk statistics and an improvement in return (see table 1). In fact, it is so close to its investment-grade counterpart in terms of worst year and maximum drawdown that they are very similar in terms of downside risk. Although market correlation does not change significantly with trend-following, change occurs where it matters: in return outcomes and losses taken. An investor may be able to avoid large losses in credit investments while reaching for return.

Things to consider with any trend-following strategy are trade frequency, trading costs, and realized gains in taxable accounts. We have found in our practice that a five-day buffer rule helps reduce trading frequency and trading costs that in a non-commission world are already very low. The largest, most plain vanilla ETFs are useful for implementing a strategy. For the U.S. corporate high-yield asset class, we have used the SPDR Bloomberg Barclays High Yield Bond ETF for its high level of liquidity and low cost. The safe security can be any of the larger high investment-grade bond ETFs, whether these investments are in U.S. Treasury securities or other high investment-grade spread sectors.

OPTIONS-BASED STRATEGIES

Often in the world of liquid and illiquid alternatives, options-based strategies provide another fixed income alternative, particularly in terms of their low correlation to equities. Often, however, their return potential is more in capital appreciation than income.

Covered calls. One method we have used to generate income and total return for clients is to write out-of-the-money calls on value stocks. In many cases, we write these above our margin of safety, so that there is often 10 percent to 20 percent capital appreciation before an option is called. In most years the calls are limited, but in some cases, such as the fourth quarter of 2020, the level of market appreciation can be substantial and many of your calls get exercised. In average markets, calls don't get exercised and premiums, though modest, can add income.

Vertical spreads. This is a version of many of the buffer strategies that have come to market lately, where the upside is capped and a degree of first loss protection is provided. In many cases these strategies keep the dividend and charge fees comparable to those of other actively managed open-end funds. Instead of using indexes to buffer, we use a basket of dividend-paying stocks.

For example, we purchase a put that is at or close to the money of the underlying security, and we pay for it with two other options. The sale of an out-of-the-money call generates premium income, and the difference between the strike and the current stock price forms a cap for the appreciation potential of the overall position. The sale of an out-of-the-money put generates the additional premium, and the difference between the long put's strike price and short put's strike price establishes the buffer for first loss (see figure 2).

An example of a vertical spread with a stock is AT&T (see table 2). We purchased a put close to the money in February 2021 and paid for it by selling an out-of-the-money call and an out-of-the-money put. In effect, we created a scenario where there was upside potential until the strike price and expiration of the call and a degree of loss protection on the downside with the combination of puts. On the long position in AT&T, which has paid its dividend for more than a quarter century up until 2021, we continue to receive the dividend.

As can be seen from table 2, the execution prices weren't perfectly matched, but the matching was close enough to offer the degree of protection we wanted. By way of the vertical spread, we get a security that pays more than the typical high-yield bond and with less of the beta and credit risk. Implementation that incorporates diversification, as well as the size of contracts, leads us to prefer larger accounts, typically in excess of $1 million, for such strategies. Of course, to implement such strategies, advisors, or their investment staffs, should have sufficient knowledge and experience with going long and short options.

SURVEY OF NEW PRODUCTS

It is much easier to buy products off the shelf than implement individual security strategies. We consider several fund solutions, by no means exhaustively.

Figure 2

PAYOFF OF VERTICAL SPREAD WITH HIGH DIVIDEND PAYING STOCK

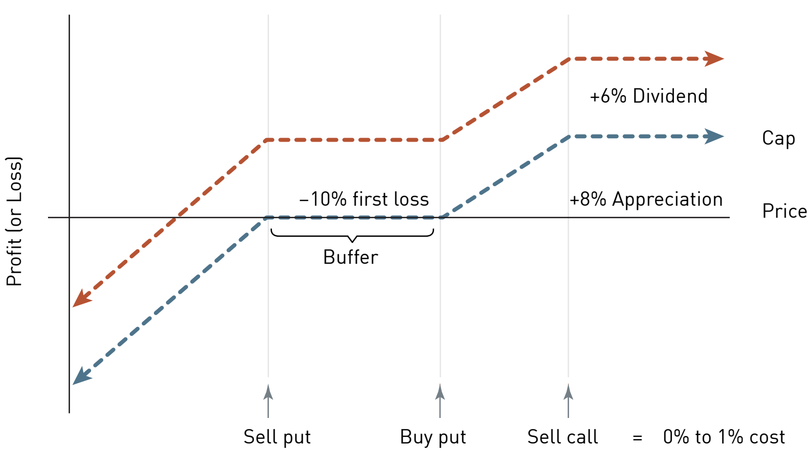


Table 2

VERTICAL SPREAD EXAMPLE WITH AT&T

	Price	Shares Purchased	Market Value		
Long Position on February 17, 2021	$29.57	7,000	$206,990		
Options Actions Taken	**Cost**	**Contracts**	**Market Value**	**Strike Price**	**Expiration**
Buy Put	$(1.97)	70	$(13,790)	28	9/17/2021
Sell Call	$0.90	70	$6,300	32	9/17/2021
Sell Put	$0.97	70	$6,790	25	9/17/2021
			$13,090		
Net Premium Paid			$(700)		
% of Long Position			−0.34%		
Forward dividend yield on February 25, 2017			7.13%		
First Loss protected below $28*			−10.71%		
Capital Appreciation up to $32**			8.22%		

**Includes the first loss between $29.57 and first strike price, which is −5.3%.*
***This is calculated from the price on February 17, 2021.*

The number of strategies in the liquid alternatives category can be daunting. However, the goal is to provide a lack of correlation to many assets, not just equities, with an occasional emphasis on income, by utilizing long-short strategies on various asset classes. One such strategy is the VictoryShares Market Neutral Income Fund. Its 100-percent rules-based approach takes a long position in dividend-paying equities and uses short index futures to hedge potential price declines. A second layer of futures positions helps address the remaining value bias that results from being long dividend stocks and short blended index futures. With a Securities and Exchange Commission (SEC) yield of more than 2 percent and a positive total return during the coronavirus sell-off of 2020,[2] this strategy combines a low to negative correlation to equities with income.

Options-based strategies, beyond the buffer wrappers mentioned below, also exist in a variety of forms. For example, the GlobalX Nasdaq 100 Covered Call ETF generates income by selling or writing calls on the index in its name. There are, however, always risks in most income-based option strategies. The GlobalX ETF captures nearly two-thirds of the downside of the index. Other options-based ETFs capture other strategy combinations, such as collars, net credit premiums, iron condors, and many other options-trading strategies. The key is to understand how these will perform in every type of scenario possible.

Among trend-following ETFs, the Pacer TrendPilot U.S. Bond ETF is an interesting alternative, one we have used in the past. It allows investors to collect income on par with high-yield bonds and potentially damp some of the risk of the asset class. It follows a rules-based strategy with three signals to alternate exposure between the S&P U.S. High Yield Corporate Bond Index and the S&P U.S. Treasury Bond 7–10 Year Index.

Buffer ETFs, notes, and similar structures also are proliferating in the market. Among ETFs, Innovator ETFs, FirstTrust, and others have rolled out buffer strategies. Many insurance companies also are entering the market with their own products. These products are not new; firms such as AXA were doing this as far back as 10 years ago, if not longer. Some companies, such as WisdomTree, advocate allocating equities to dividend-paying ETFs.

Interest in the alternative credit space is picking up again, and private credit, primarily in the form of direct lending, is becoming more accessible to investors, particularly if they meet the accredited-investor or qualified-purchaser standard.

These are but a few of the options that have arisen to address the 60/40 challenge. Other good solutions exist if you look for them.

CONCLUSION

At the end of the second quarter, the rate on a 10-year U.S. Treasury bond is close to 1.5 percent. The three-month T-bill yields close to 0 percent. Unemployment still hasn't reached pre-recession lows. Sounds familiar, right? But it's not 2021, it's 2012.

Not everything is the same, of course. Credit spreads were higher in 2012, but the 2012 base yield curve was close to what it is now. From July 1, 2012, to July 31, 2021, the S&P 500 Index returned 16.07 percent annually, and the Bloomberg Barclays U.S. Aggregate Bond Index returned 3.05 percent annually. Everything turned out fine.

We know we can't extrapolate the past into the future, but we believe in positive, yet tempered, outcomes in the near and far future for the 60/40.

In this survey of options, we recommend what we have implemented ourselves. For large accounts, we have implemented options-based strategies and introduced private credit. For other accounts, given client suitability, we have increased equity allocations. We've refrained, however, from introducing meaningful positions in commodities, despite the year-over-year inflation numbers in 2021, given their generally lower return prospects versus volatility in the long term.

We've made the most change in the 40 percent itself. We have created a core-plus allocation that is investment grade, up to 70 percent of a portfolio. We have included some Treasury Inflation-Protected Securities as partial insurance against non-transitory inflation. We have complemented the investment-grade core with higher-yielding securities, primarily in U.S. high-yield and emerging-market debt. These complements mostly follow a rules-based trend-following approach to mitigate any widening of the credit spread. We also have shortened duration without too substantial a bet against the direction of interest rates. It is our hope that we can get 100–200 basis points in the next three to seven years above the current SEC yield of the Bloomberg Barclays U.S. Aggregate Bond Index, which stood at about 1.35 percent as of June 30, 2021, without substantially more risk. These are our realistic expectations.

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ENDNOTES

1. Portfolio Visualizer is an online software product for investment analytics, www.portfoliovisualizer.com.
2. Source: Morningstar Office: 1.25-percent total return on CBHIX (February 20, 2020–March 23, 2020).

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