Purpose of Bonds in Portfolio Management

The current near-zero short-term rates, unprecedented fiscal stimulus, and a higher Federal Reserve inflation target indicate that long-term interest rates could finally begin to rise. Rising interest rates impact bond returns in that when rates rise, bond prices initially fall. So, should investors continue to hold bonds in their portfolios?

In this article, we explore the role of bonds in a portfolio, our strategy for bond allocation, and discuss how we are adjusting bond exposure in our portfolios in response to potentially rising rates.

Volatility Damper and Consistent Return

One of the biggest threats to balanced portfolios is an unexpected shock to stock prices. Because of the consistent returns delivered by bonds, they have traditionally provided a ballast in investment portfolios. Bonds enable a portfolio to weather stock market volatility, thus providing consistent portfolio returns.

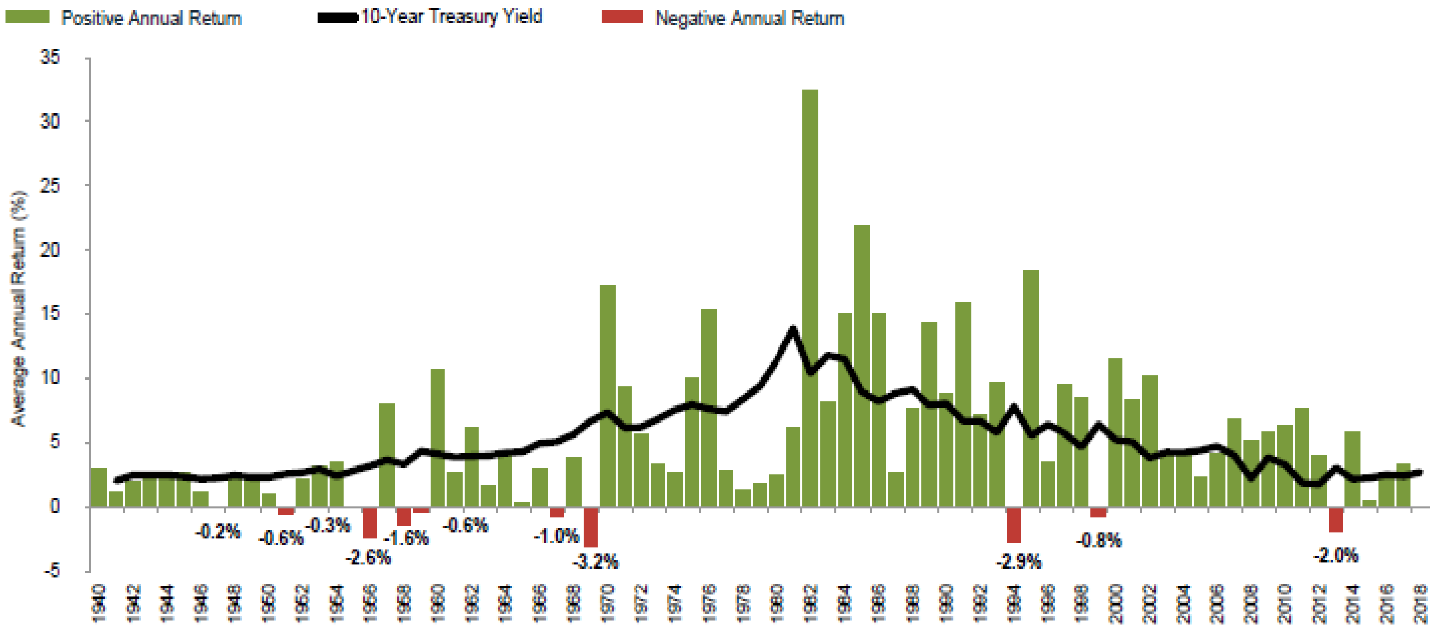
To illustrate, let us consider the basis for bond returns. Most bonds pay their holders a fixed interest rate over the bond's life. This interest, known as the coupon, remains constant, independent of fluctuations in the bond's market price. When a bond reaches maturity, the bond's original value, or face value, is returned to the bond holder.

The total return on a bond investment held to maturity is simply a function of the bond's interest rate plus any bond pricing changes. This interest is paid regularly throughout the bond's life. In contrast, a stock's total return is based on stock price gain/loss plus a dividend payment. Unlike bond interest, stock dividends are not guaranteed, fluctuate in value and depend on company performance.

Because of their structure, bonds historically provide consistent, usually positive, returns, averaging near 5.3%. The chart below shows relatively few losing years for bonds since 1940 with the steepest decline at -3.2 %.[1] By comparison, the S&P 500 Index averages three negative years out of ten and has had severe return years, as steep as -37%.[2]

U.S. Bond Returns (1940 – 2018) [1]

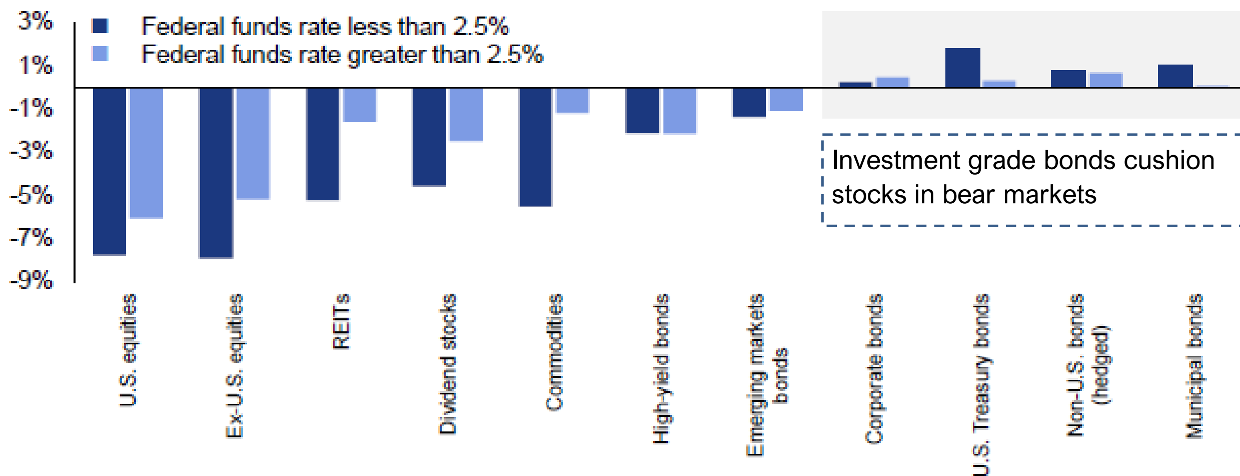
AVERAGE ANNUAL RETURN: 5.3%



We consider bonds the best protection against stock market risk, and bonds play a risk management role in most of our portfolios. Bonds historically have a near-zero correlation with stocks. When economic trouble strikes, as with the 2008 – 2009 banking crisis, high-quality bonds, such as U.S. Government-backed treasuries, are generally the only safe assets. During the most recent COVID-19 crisis period, January through March 2020, global bonds had slightly positive returns while stocks returned -16%. [3] The chart on the following page shows how bonds performed during the worst months for stocks over the last 30 years, including one of the toughest 20-year investment periods, 1992 – 2012. [4]

Bond Performance During Worst Stock Performance Months [4]

Median return of various asset classes during the worst decile of monthly equity returns, 1988–2019



The portfolio protection provided by bonds varies over time. However, Sharper Granite research finds that bonds tend to move differently from stocks, especially when needed – during times of extreme shock.[5] This action, whereby bonds and stocks move in different directions, is exactly the anti-correlative behavior that delivers steady, risk-adjusted performance.

Income, Liquidity, and Inflation Protection

While behaving as insurance against stock declines, high-quality bonds pay interest in any environment and virtually guarantee repayment of principal after a set term. This constant income stream provides a flow of funds in retirement or a steady stream of new funds to invest during accumulation years. In fact, as our clients transition into retirement, we gradually tilt more of their portfolio allocation toward bond holdings to maximize income and safety of the income stream.

Another reason for holding bonds is access to liquidity. The $51 trillion U.S. bond market and the emergence of efficient bond funds provide a generous level of market liquidity for bonds.[6] By comparison, the U.S. stock market totals $46 trillion in value.[7] When needed, the sizeable bond market allows investors to raise cash from bond holdings instead of selling stock in down markets. Additionally, bonds have little to no capital gains as they derive most of their returns from interest, so bonds may often be sold with little tax consequences. Bond liquidity adds great flexibility to financial planning.

Finally, some bonds can help keep up with inflation. These are "inflation-protected" bonds. This means that interest payments increase when inflation rises and, conversely, payments decrease when inflations falls. Most inflation-protected bonds are government issued.

Strategy for Bond Allocation

Rising rates hurt bonds initially but eventually help bonds. Because yields on new bonds are higher in high-rate environments, as old bonds eventually mature, they renew at higher yields.

A well-structured bond ladder can take full advantage of this rising-rate effect. A bond ladder is a set of individual bonds with different maturities. As the short-term bonds mature, funds are used to buy longer-term bonds, which typically offer higher yields, especially when rates are rising. Thus, the average yield of the bond portfolio rises if rates rise or stay constant. Laddering individual bonds at different maturity dates eliminates much of the adversity of rising interest rates.

Another key strategy for high earners in California is the use of municipal bonds. For couples earning over $450,000, the need for tax-free income increases dramatically. High earners in California and Oregon now face marginal income tax rates over 50%. For these investors, a laddered California municipal bond strategy often adds tremendous after-tax value. For example, an A-rated California municipal bond yielding 3% generates pre-tax equivalent annual income of approximately 6% with nearly zero chance of default.[8] This virtually guaranteed return rate is incredible in today's low-rate environment.

Response to Rising Rates

Although bonds have historically provided consistent returns, our performance projections for the coming years are modest. And, in fact, we are taking action to mitigate bond exposure to rising rates. These include shortening portfolio bond duration, utilizing inflation-protected bonds, adding small amounts of commodity exposure, tilting away from bonds and toward high-dividend stocks, and emphasizing individual bond ladders where appropriate.

We still believe bonds are an important part of most investment strategies. In investing, what ultimately matters is risk-adjusted, after-tax performance of the entire portfolio, and bonds play a key role. Their consistent returns provide a form of insurance against the most challenging economic conditions, even rising rates.

Our return simulators show that despite low yields, bonds can be expected to remain one of the best hedges against stock market risk and continue to provide meaningful downside protection for long-term investors holding well-diversified portfolios.

Notes and Acknowledgements:

1. "Why Bonds Now? The Durability of Bond Returns," Fidelity, December 31, 2018.
2. Dimensional Matrix Book 2021.
3. Vanguard, "Rising Rates Don't Negate Benefits of Bonds," Roger Allaga-Diaz, PhD, 2021.
4. Vanguard, "Why Buy Bonds with Yields so Low?", 2021.
5. Sharper Granite research. Stocks measured by the S&P 500 Index. Bonds measured by the Barclays Aggregate U.S. Bond Index from 1976 – 2012 and by a composite of the IA SBBI Intermediate-term Government Bond Index and the IA SBBI Long-term Corporate Bond Index from 1926 – 1975, Fidelity, Fall, 2013.
6. U.S. Fixed Income Securities Statistics as of 4Q2020, Securities Industry and Financial Markets Association, includes Municipal, Treasury, Mortgage-related, Corporate Debt, Federal Agency Securities, Asset-backed and Money Market.
7. U.S. Equity and Related Markets Research Quarterly for 1Q2021. Securities Industry and Financial Markets Association, April 2021.
8. Sharper Granite research, uses Barclays Aggregate bond index data for bonds and uses S&P 500 Index data for stocks.

All forms of securities investing involve risk of loss for which clients should be prepared. There are no guarantees or insurances of principal preservation and market fluctuations of any level may occur and impact portfolio value. Past performance is not a good predictor of future performance.