



▶ Think Again, Tree 2020



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IS BORING THE NEW GROOVY?

After a decade of zero interest rate monetary policies that ended in a bloodshed for bond investors in 2022, the investment landscape has finally returned to a more traditional backdrop: higher rates and more attractive fixed income. Goldilocks and TINA (There Is No Alternative) are now gone and investors need to rethink asset allocation accordingly: fixed income, a long-time-no-see asset class is back in fashion and has a lot to offer in the next few years, especially compared to its riskier equity counterparts.

How should investors position portfolios for the months and years to come? What is the best way to take advantage of this window of opportunity? How long will it last? All these questions must be addressed.

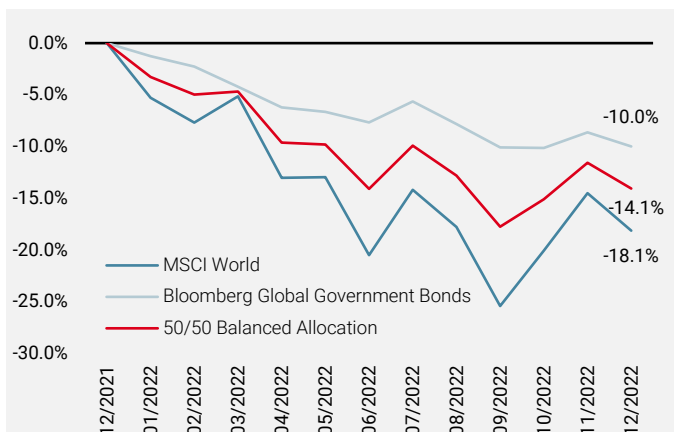
THE FIXED INCOME OPPORTUNITY - RELOADED

WITH GREAT CRISES COME GREAT OPPORTUNITIES.

The pain caused for bond investors by the sharpest and swiftest tightening cycle of the past four decades may only be equalled by the opportunity it now presents. For the first time in most money managers' careers, the "safe" allocation in diversified portfolios detracted - a lot - and at the worst of times given stock indices incurred heavy losses as well. Looking at so-called "balanced" portfolios (holding as much bonds as stocks), the proportion of the current drawdown driven by the fixed income sleeve has for the first time durably exceeded 50%, leaving asset owners and asset managers in shock, with nowhere to hide.

A tale of blood, sweat and tears.

Figure 1: An unprecedented correlation shock



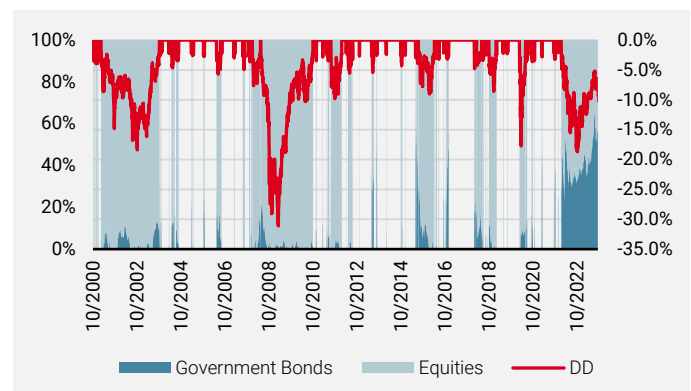
Source: Bloomberg, Unigestion. As of 31.10.2023.

Over the past 20+ years, three distinct phases of equity/bond relationships have been observed, as shown in Figure 1. Between 2000 and 2010, the correlation between the two asset classes was intuitive (if not normal): sovereign bonds offered positive returns during equity corrections and any pain suffered by bond investors during "bad times" was usually either non-existent (meaning returns remained positive) or low, averaging a proportion of 5%.

During the post-GFC era, between 2010 and 2020, this proportion increased to 10%, with brief peaks observed during 2013's taper tantrum and 2015-2018's tightening cycle.

The third and last phase has been the post-Covid era, and the major correlation shock that ensued, with the correlation between bonds and equities converging to 1 and the proportion of bond losses rising to 50% durably in 50/50 balanced allocations.

Figure 2: Contributors to diversified portfolios drawdowns



Source: Bloomberg, Unigestion. As of 31.10.2023.

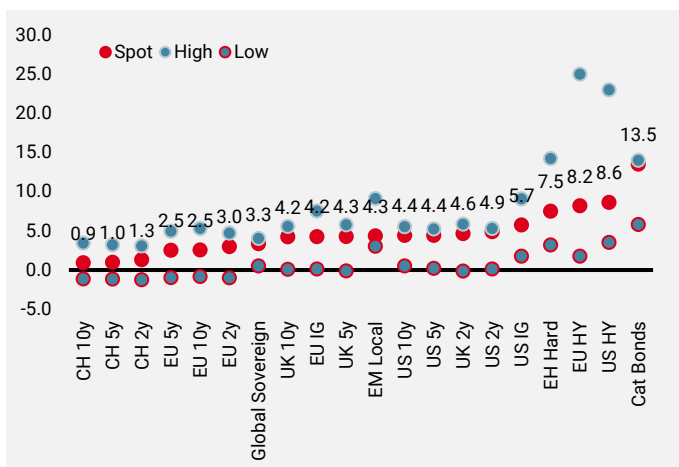
The pain was real, but what does it mean for the future?

The first good news is that expected returns in the fixed income space have not been as high for at least 15 years. Cash equivalents offer 5% over a year in US Dollar terms, risk free. Adjusted for inflation, they still yield positive returns, a situation unseen for a while too.

The second good news is that with interest rates being the yield basis for any bond sub asset class, the entire fixed income universe is now offering much more attractive carry (which may even exceed the equity dividend yield) at much lower risk. Figure 3 puts things into historical perspective on a wide range of asset classes. An interesting takeaway is to observe that the US two year yield is now superior to that offered by speculative-grade bonds (high yield) in 2021.

Not a surprise then to see large scale allocation shifts happening.

Figure 3: Fixed income yields – 2000-2023



Source: Bloomberg, Unigestion. As of 31.10.2023.

As one of the questions is whether bonds are always competitive against stocks or not, the answer lies - as often - in the observation window. Over the long run, the risk/reward ladder scale is somewhat respected: cash is the safer/lower performing asset; stocks and high yield bonds the riskier/higher performing ones. On a risk comparable basis however, using sharpe ratios, bonds have a clear advantage.

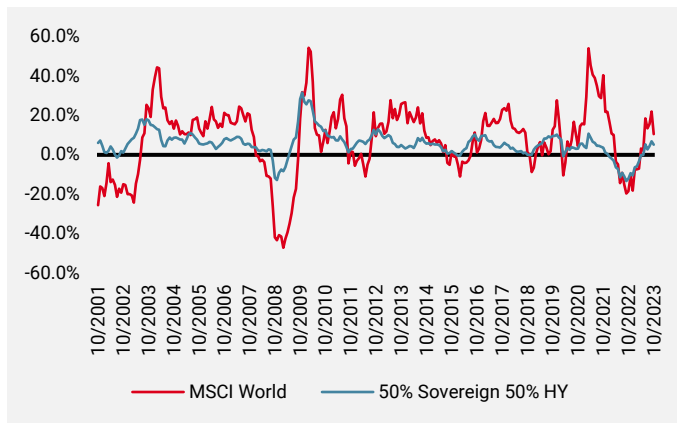
Table 1: Performance & Statistics comparison (2000-2023)

	Global Sovereign	Global IG	Global HY	ST Cash Usd	MSCI World	50% Sovereign 50% HY
Ann. Return	3.5%	4.2%	6.9%	1.8%	5.3%	5.3%
Ann. Volatility	3.1%	4.9%	9.3%	0.5%	15.7%	5.0%
Sharpe	0.6	0.5	0.6		0.2	0.8
Max. DD	-11.6%	-18.1%	-31.4%	0.0%	-54.0%	-14.1%

Source: Unigestion, Bloomberg as of 31.10.2023

Over shorter timeframes, stocks can significantly outperform bonds and vice versa, as depicted in Figure 3. So, the point is rather to identify patterns to try to predict the timely competitive advantage one will have over the other.

Figure 4: 1-year rolling returns



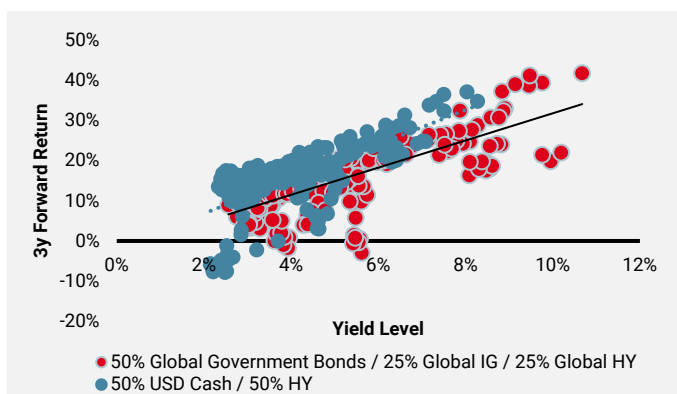
Source: Bloomberg, Unigestion. As of 31.10.2023.

PATH DEPENDENCY... WHEN TIMING IS KEY

As intuition can be misleading at times, let's proof test some assumptions. The higher the expected return, the higher the realised return for example.

Figure 5 illustrates this relationship by comparing yields at any given point in time (x) with one year forward total returns (y). Two major observations can be drawn: firstly, it does confirm that on average, a higher yield environment does offer superior absolute returns. Secondly, and more importantly, the dispersion of realised returns diminishes past a certain threshold.

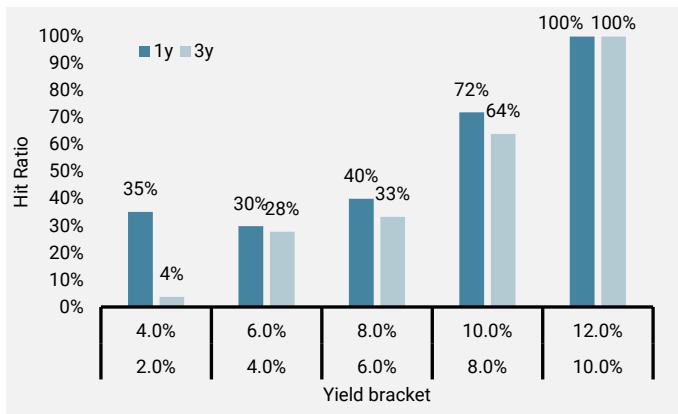
Figure 5: Conditional Forward Returns



Source: Bloomberg, Unigestion. As of 31.10.2023.

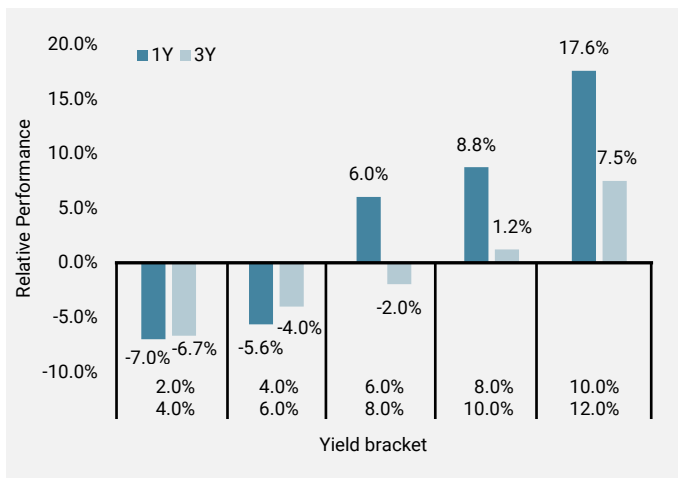
Looking at relative returns, it becomes clear that starting yields need to be quite elevated to beat their equity counterparts. Figure 6a showcases hit ratios of a 50% cash/50% high yield allocation against a portfolio only invested in equities over one and three years, contingent to the current level of yield. 6b measures the relative performance of the first over the former over the same time frames. The first observation confirms the above-mentioned intuitive relationship between absolute levels of yields and forward-looking returns, and identifies the important thresholds of competitiveness: when starting yields are superior to 7.5%, the batting average rises rapidly above 60%, while average outperformance turns positive.

Figure 6a: Conditional Hit Ratios



Source: Bloomberg, Unigestion. As of 31.10.2023.

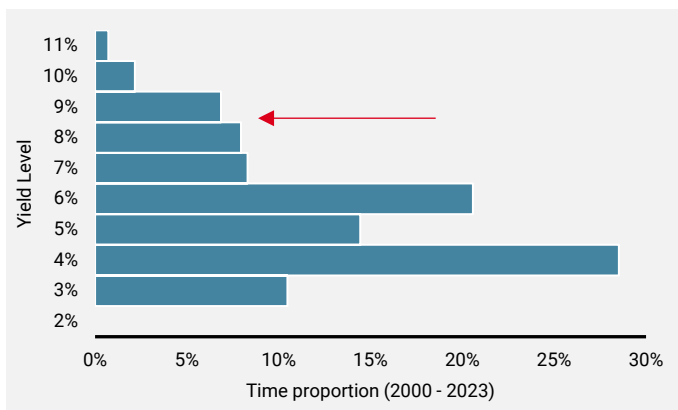
Figure 6b: Conditional Forward Relative Performance



Source: Bloomberg, Unigestion. As of 31.10.2023.

With yields currently standing at approximately 8% for an allocation comprised of cash equivalents (short term treasuries) and high yield exposures, it becomes clear that **the time to reflect on strategic allocation changes has come.**

Figure 7: Current conditions

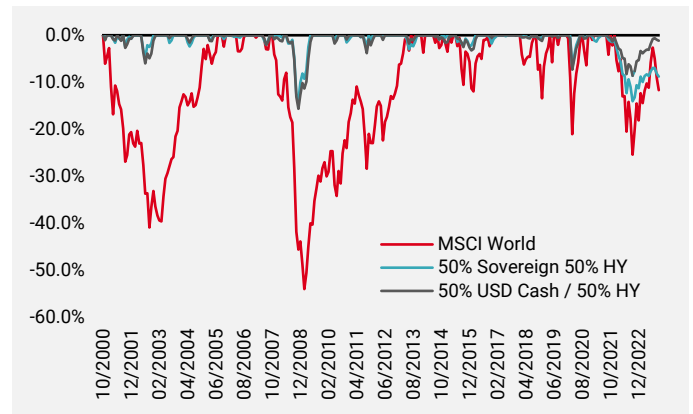


Source: Bloomberg, Unigestion. As of 31.10.2023.

While it appears like an opportune time to reconsider fixed income as a very valid alternative to stocks from a “probability of success” perspective, investors also need to consider risk.

Volatility, the measure of the quantity of periodical divergence of a variable around its own mean or, put differently, how uncertain can a return stream be, offers a major advantage to bond allocations, independent of the time horizon. Over the past 20 years, fixed income volatility has been three times lower than the volatility of stocks - an appealing feature not to be overlooked. Looking at risk from a maximum loss angle, as depicted in Figure 8, once again the advantage resides with boring bonds again.

Figure 8: Rolling Drawdowns



Source: Unigestion, Bloomberg

Concluding Remarks

“Boring: Adj.: Not interesting or exciting”.

High expected returns, lower risk and better visibility are among the major “pros” highlighting the revived attraction of fixed income. A “con” would be the ‘Fear Of Missing Out’ (FOMO) on equity returns notwithstanding one’s view on the future performance of stocks. To circumvent FOMO risk, the barbel approach that consists of keeping a large portion of assets invested into cash equivalents offers great flexibility and valid options to get exposed to stocks when needed. This can be achieved either simply by re-arbitraging into the asset class from the cash sleeve at levels deemed attractive, or by engaging into optional overlays, or any other convex/asymmetric solutions.

“BORING” HAS NOT BECOME THE NEW “GROOVY”, IT HAS JUST BECOME AN EXCITING OPPORTUNITY AFTER ALL...

Strategically, arbitraging risk exposures for fixed income seems very opportune today and will enable investors, via buy and hold strategies, to lock in high fixed returns on assets for the years to come, just like it was opportune to lock low rates on liabilities during the ZIRP era. If good times arise, capital appreciation could offer an extra kick to coupon clipping; if stress resurges, such allocations will prove way more resilient and allow investors to seize opportunities in stocks as they arise. Unless one believes in 10%+ annualised returns in equities for the next three to five years, it may be time to go boring, or go home.

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