

INSIGHTS FROM CFA SOCIETY SINGAPORE

Bonds and fixed income: Where's the hedge?

Bonds and other fixed-income assets are supposed to offer diversification benefits, especially in rough times. But how have they really performed?

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IT IS no secret that 2022 has been a rough year for pretty much all asset classes across the board.

While US equities have fallen more than 20 per cent, the average fixed-income security has not fared much better: Most are down at least 10 per cent.

Of course, bonds and other fixed-income assets are supposed to offer diversification benefits and provide something of a cushion for when the equity component of a portfolio runs into rough times. Clearly, they are not performing these functions especially well of late.

With this in mind, we sought to understand when fixed-income assets have actually done what portfolio managers and investors expect them to do.

We looked at returns for the S&P 500 and the average total bond fund going back to 1970 and analysed how the correlations between them have changed over time.

We tested the correlations over different interest rate environments, as well as in changing rate



environments. So, what did we find? With the federal funds rate serving as a proxy, the highest correlation between fixed-income and equity returns has occurred in rising rate environments.

This mirrors the current predicament. As the US Federal Reserve seeks to rein in inflation, bond returns are not ameliorating the equity market losses but are, in fact, falling more or less in tandem with stocks.

Indeed, we find that the correla-

tion between stocks and bonds is lowest in flat interest rate environments. Whether this is because such environments correspond to the most stable of economic times is an open question.

Nevertheless, whatever the cause, bonds and fixed income seem to offer the most diversification benefits and the least correlation with equities when interest rates are static.

We next examined stock-bond correlations during low, medium,

Data suggests that it is precisely when fixed income's diversification benefits are most needed – during a recession – that they are least effective. PHOTO: PIXABAY

and high interest rate environments, that is when the federal funds rate is below 3 per cent, between 3 per cent and 7 per cent, and above 7 per cent, respectively.

Here, we found that stock and bond correlations are highest when the federal funds rate is above 7 per cent.

Conversely, bonds offer the most diversification benefits, or the least correlation with equities, during low rate environments.

Finally, we explored how the benefits of diversification shift during recessions.

To do this, we isolated the correlation between stocks and bonds at the outset of each of the seven recessions that have occurred since 1970, and then compared that to the stock-bond correlation at the conclusion of that particular recession.

In five of the seven recessions, the correlations increased, with the largest spikes occurring during

Average stock-bond correlation by rate environment

Rising Rates	0.5257
Flat Rates	0.3452
Falling Rates	0.4523

Stock-bond correlations in different federal funds rate environments

Above 7%	0.5698
Between 3% and 7%	0.4236
Under 3%	0.2954

Stock-bond correlations during recessions

	END OF RECESSION	START OF RECESSION	CHANGE
November 1973 to March 1975	0.793	0.7095	0.0835
January 1980 to July 1980	0.4102	0.7569	-0.3468
July 1981 to November 1982	0.6955	0.0282	0.6673
July 1999 to March 1991	0.7807	0.5156	0.2651
March 2001 to November 2001	-0.1957	0.3754	-0.571
December 2007 to June 2009	0.8284	-0.2149	1.0433
February 2020 to April 2020	0.7364	0.3369	0.3995

Source: Derek Horstmeyer, Jason Huddler and Jianyu Ren

the 1981 recession and in the Great Recession.

What lesson can we draw from this?

That it is precisely when fixed income's diversification benefits are most needed – during a recession – that they are least effective.

This presents a sizeable dilemma for investors and portfolio managers alike.

Amid recession or rising rate environments, we cannot count on fixed income's hedging effect.

Which means we need to look to other assets classes – perhaps commodities or derivatives – for protection in bear markets.

Of course, they may not be capable of filling the gap either.

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