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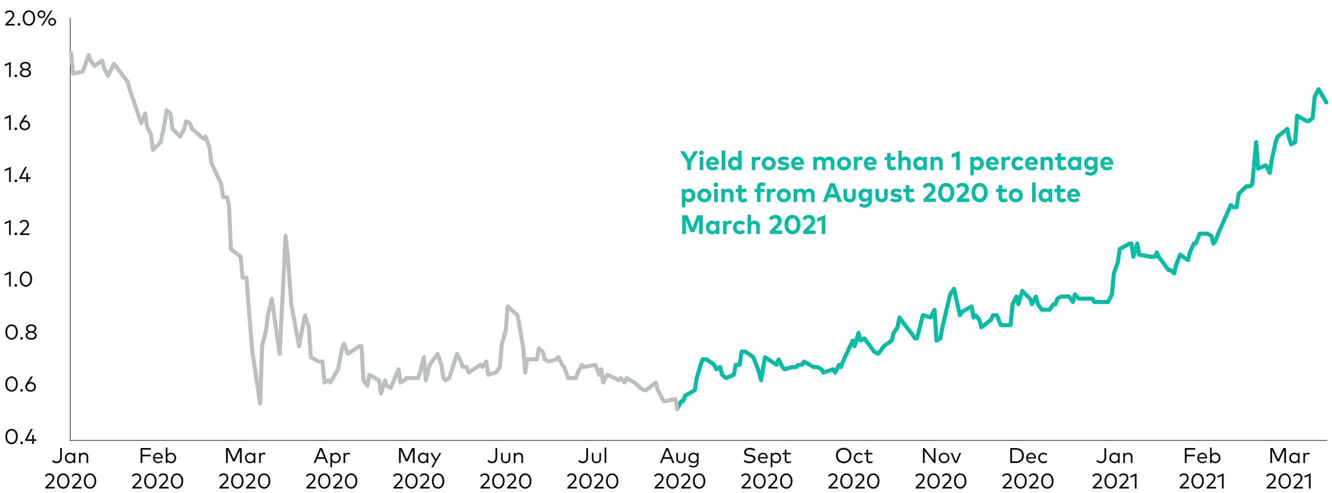
Rising rates don't negate benefits of bonds

The yield of the 10-year U.S. Treasury note rose more than 100 basis points (1 percentage point) from August 2020 through late March 2021. Rates also climbed for other government bonds, including those issued by the United Kingdom and Australia. Because bond prices fall as rates rise, and vice versa, some investors are feeling jittery about the near-term risks of bonds.

Rising bond yields mean lower bond prices

Daily yield of the 10-year U.S. Treasury note, January 2, 2020–March 22, 2021



Source: U.S. Department of the Treasury.

Bond investors should hold, not fold

In such market cycles, it's particularly important to keep in mind the role bonds play in a diversified investment portfolio—to be a shock absorber at times when equity prices head downward.

Vanguard research found that when stocks worldwide sank an average of roughly 34% during the global financial crisis, the market for investment-grade bonds returned more than 8%. Similarly, from January through March 2020—the period encompassing the height of volatility in equities due to the COVID-19 pandemic—bonds worldwide returned just over 1% while equities fell by almost 16%. And if we look at the markets over several full business cycles, from January 1988 through November 2020, whenever monthly equity returns were down, monthly bond returns remained positive about 71% of the time.[1]

Such uncorrelated returns demonstrate the diversification benefits that a balanced portfolio of stocks and bonds offers investors.

[1] Renzi-Ricci, Giulio, and Lucas Baynes, 2021. *Hedging Equity Downside Risk With Bonds in the Low-Yield Environment*. Valley Forge, Pa.: The Vanguard Group.

In short, don't let changes in interest rates drive a strategic shift in your bond allocation. Myths and misconceptions regarding bond investing abound during periods of rising rates, often coupled with calls for drastic changes to your portfolio. Here are three common myths that investors should avoid:

MYTH

"Bonds are a bad idea—abandon the 60/40 portfolio."

1

This oft-heard recommendation contradicts the overriding importance of maintaining a balanced allocation that suits your investment objectives, plus it may be too late to gain any benefit from a tactical shift in your asset allocation. Selling bonds after the recent increase in rates, which has driven down prices and total returns, is simply chasing past performance. Investors should stay forward-looking: At current higher yields, the outlook for bonds is actually better than before yields went up. Bear in mind that the upside of higher yields—greater interest income—is coming.

Also, the odds of future capital losses decline as yields increase. So now is not the time to abandon bond allocations. On the contrary, the more that bond yields rise (and prices fall), the more important it is for long-term investors to maintain a strategic allocation to bonds, which could require rebalancing into bonds, not the other way around.

MYTH

"Go to cash, avoid duration risk."

2

Rising rates have hit long-term bonds the hardest. But the recommendation to avoid duration or interest rate risk is backward-looking and probably comes too late. Again, shift your mindset to a forward-looking view of the bond market. The market consensus is that rates will rise, and the prices of short-, intermediate-, and long-term issues already reflect that belief.

Today's market prices for longer-term bonds already factor in investors' expectations for rising rates, which is why prices are cheaper. If that consensus view were to play out, there would be no advantage in shifting to shorter-term bonds or going to cash. Such moves would pay off only if longer-term yields were to rise more than expected. However, it's equally likely that yields will rise less than expected, in which case long-term bonds would do better.

MYTH

"When interest rates are rising, don't just stand there—do something!"

3

The past stretch of rising rates was a surprise to the markets, but now markets expect continued increases. That rates are rising is not really news anymore. While yields indeed seem likely to rise, they may do so by either more or less than the market consensus. Control what you can: With a 50/50 chance of rates rising more or less than consensus, a better approach than trying to pick which market segments will fare best in the near term is to stay well-diversified for the long term across the maturity spectrum and across asset classes.

Keep your eyes on the road ahead

It's good advice in both driving and investing. Vanguard recommends that investors stay focused on long-term, forward-looking return expectations, not on recent trailing-return performance.

Let your investment goals shape decisions about your strategic asset allocation. Calibrate the risk–return trade-off in your portfolio accordingly, including setting the right mix of bonds and stocks to meet those goals. And generally ignore market-timing advice, which is mostly based on public consensus information that is already priced into the markets. Even if rates keep rising, long-term total returns on broadly diversified bond portfolios are likely to remain positive. That would be the natural outcome of reinvesting bond dividends at higher yields, a process that's easily managed by owning mutual funds or ETFs.

The elephant in the room—inflation

Inflation is often seen as the enemy of the fixed income investor—in particular, unexpected inflation that the market hasn't priced in. Inflation-indexed securities provide a limited hedge against unexpected inflation.

Vanguard research suggests that significant inflation hedging through inflation-linked securities requires large positions, which could reduce the other diversification benefits of a bond allocation in a portfolio. Over long time horizons, equities historically have provided the strongest safeguard against inflation.[2]

Where active can shine

A rising rate environment also accentuates what skilled active managers may be able to bring to a bond portfolio. When yields are falling, outperforming fund managers pile their excess returns on top of the market's generally rising prices. But amid the headwinds of rising rates and prevailing price declines, successful active fund managers may make the difference between positive and negative total returns.

Investors who are inclined to seek outperformance—and are cognizant of the risk of underperformance—should leave decisions about tactical shifts and security selection to professional active managers. Those managers who have shown skill in executing repeatable investment processes, subject to strict investment risk controls—like my colleagues in Vanguard Fixed Income Group—can guide portfolios successfully through market waters, tranquil and choppy alike.[3]

[2] Bosse, Paul, 2019. *Commodities and Short-Term TIPS: How Each Combats Unexpected Inflation.* Valley Forge, Pa.: The Vanguard Group.

[3] For the 10-year period ended December 31, 2020, 38 of 44 actively managed Vanguard bond funds outperformed their peer-group averages. Results will vary for other time periods. Only funds with a minimum 10-year history were included in the comparison. (Source: Lipper, a Thomson Reuters Company.) *Note that the competitive performance data shown represent past performance, which is not a guarantee of future results, and that all investments are subject to risks. For the most recent performance, visit our website at vanguard.com/performance.*

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