The Risk/Reward of Bonds

By

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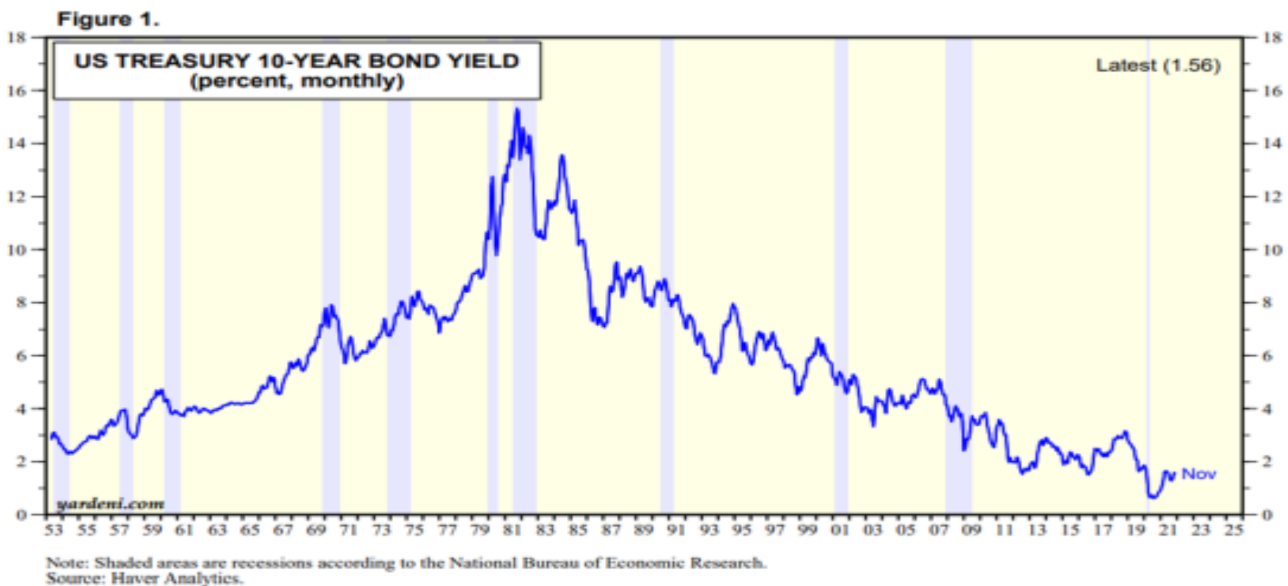
Unlike any other asset class, fixed income (bonds) has two risk/reward values:

1. Total Return
2. Certain Cash Flows

Total Return Value

The total return value in bonds is the converse of interest rate movements. When rates go down, as they have from 1981 to 2021, they produce price appreciation and higher total returns. And the opposite happens (negative price returns) when rates go up as they did from 1953 to 1981.

US Government Bond Yield



Since the start of 2022, interest rates have trended upward causing negative bond returns (BB Aggregate Index **-3.25%** YTD thru 02/28/22). Given the current inflation rate of over 7.0% on the CPI and over 9.0% for the PPI, coupled with the expectation that the Fed will raise short rates several times this year… this interest rate trend to higher rates should continue. As a result, pensions should expect negative fixed income returns this year and for the foreseeable future.

Certain Cash Flow Value

If you buy bonds for their intrinsic value (certainty of cash flows) you will **immunize or mitigate interest rate risk!** Since cash flow**s** are future values, they are not affected by interest rate movements. Moreover, any excess cash flow reinvested will be able to buy new cash flows at reduced costs. This is truly the value in bonds and we strongly recommend that pensions use bonds as their ***liquidity or Beta assets***. Let the performance or Alpha assets be the non-bond assets. Use bonds to cash flow match pension benefits and expenses chronologically. This synergy of Beta and Alpha assets should secure benefits, reduce funding costs, and buy time for the Alpha assets to grow unencumbered.

Cash flow matching by any name (defeasance, dedication, immunization) may be the oldest fixed-income strategy. It should be the core portfolio of a pension and the fixed income strategy chosen by pensions today given the likelihood of higher interest rates. Cash flow matching will secure benefits in a cost-efficient manner. The Ryan ALM cash flow matching product (**Liability Beta Portfolio™**) will reduce funding costs by about 1% per year of matching (i.e. 1-10 years = 10% funding cost reduction).

With the stock market struggling this year (S&P 500 **-10.7% YTD** thru 03/07/22), a cash flow matching bond allocation will buy time for the equity allocation to recover without any dilution to fund benefits and expenses. Let bonds be the liquidity assets to fund benefits + expenses. Let the growth assets grow unencumbered without any dilution. History tells us that 48% of the S&P 500 returns on a rolling 10-year basis come from dividends reinvested.

For info on the Ryan ALM cash flow matching product (Liability Beta Portfolio™) please contact:

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