Why Are U.S. Treasury Bonds Trading Like Growth Stocks?

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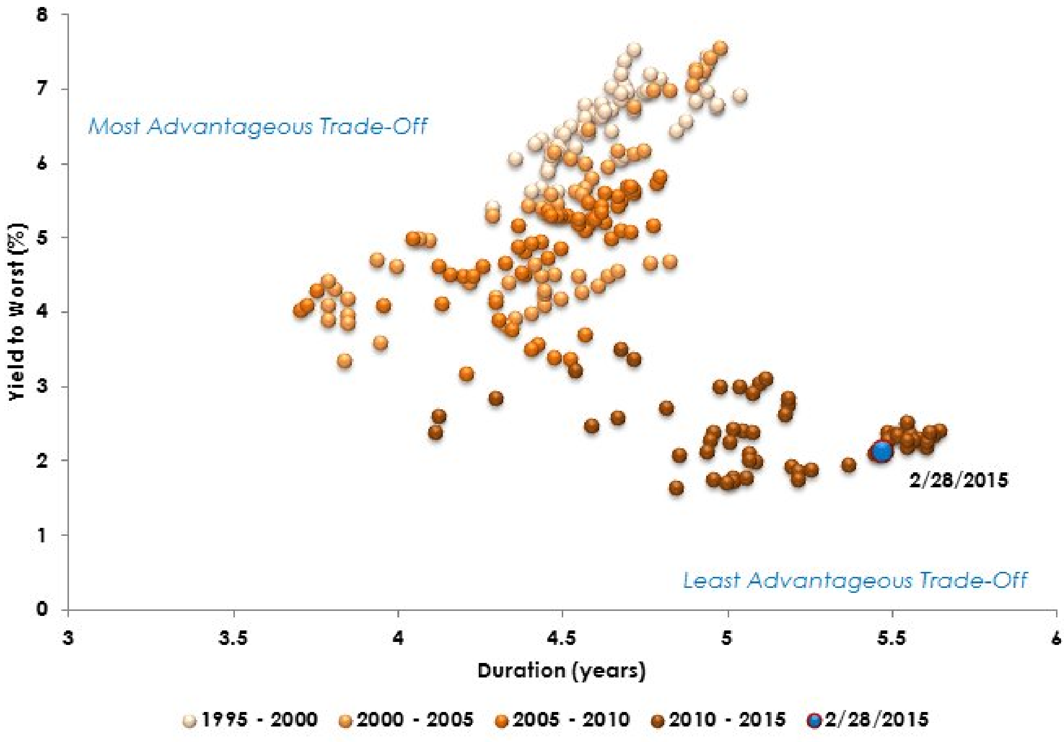
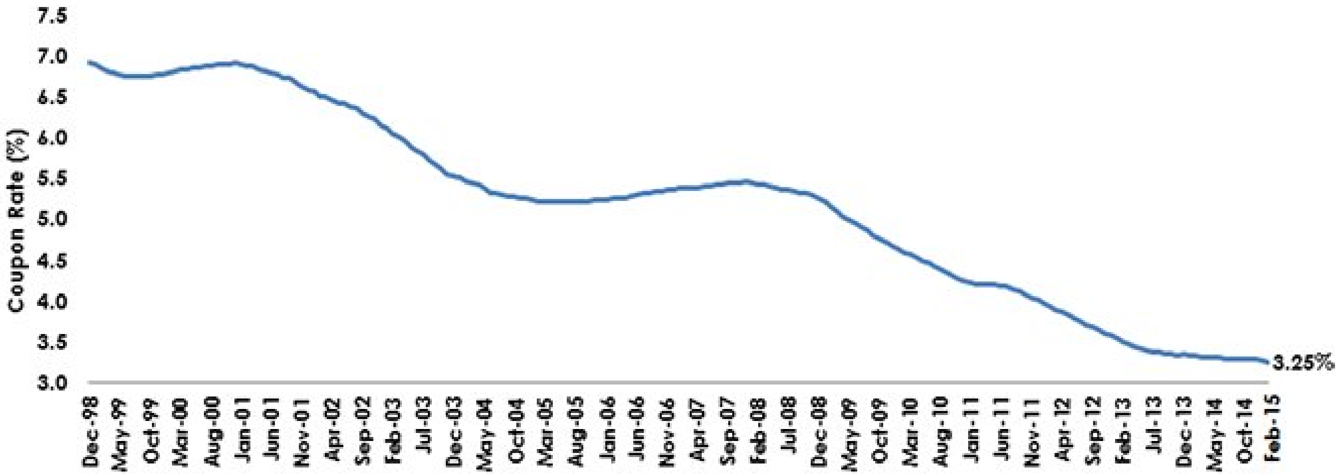
It should not be surprising that equity returns often dominate the headlines. The total returns of stocks are hypothetically infinite. A business that can generate ever-higher revenues and profits becomes ever more valuable to shareholders. With the possibility of greater upside, of course there must also be a potential for downside. Generally speaking, an equity investment whose returns are primarily based on price appreciation (as opposed to income) can be referred to as a growth stock. In contrast, nominal total returns for fixed income securities are governed by the laws of mathematics. Bond investments generally have a finite amount of time until maturity. Unless interest rates approach negative infinity before the bond matures, the general drivers of return are: 1. The initial price paid 2. The interest payments received over the life of the investment 3. The final price received at maturity Due to these constraints, the general starting point for assessing a bond's return potential is its starting yield. Despite low starting yields, bond total returns over the last decade have generally been very strong.1 As rates have fallen, bond prices have adjusted higher. The analogy between bond returns and growth stocks is that total returns in the bond market are being driven overwhelmingly by price returns, as opposed to income.2 While investors have expressed anxiety about the prospects for rising U.S. interest rates for some time, we may finally be on the cusp of a shift in policy at the Federal Reserve (Fed). Economists may continue to debate the timing of such a shift, but we believe that investors should take a proactive approach to managing interest rate risk prior to any official change. In our view, the risk of being early may be less painful than the consequence of being late. The primary catalyst for this view is not something that has happened in recent weeks but a gradual development that has occurred over the last several years in the bond market—the potential income cushion from coupon payments has eroded significantly. Coupon rates in U.S. investment-grade fixed income have fallen to some of the lowest levels in history.3 As a result, total returns from plain-vanilla fixed income over the last several years have been driven by changes in bond prices as opposed to income. In our view, the risk-versus-return tradeoff of today's fixed income markets is more akin to growth stocks than it is to bond markets in previous decades. As figure 1 shows, the current composition of the Barclays U.S. Aggregate Index illustrates some of the greatest sensitivity to changes in interest rates (duration) versus income potential (yield) in its history.4 **Figure 1: Fixed Income Risk vs. Return Barclays U.S. Aggregate Index Historical Averages: Yield to Worst vs. Duration**



Source: Barclays, as of 2/28/15
Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of terms and indexes in the chart, visit our glossary. The primary driver of these developments is the sharp fall in coupon rates that has occurred over the last few market cycles. As figure 2 shows, coupon rates are now less than half of what they were a decade ago. Once rates stop declining, eventually, the mathematics of bond pricing will pull returns back to earth. As a result, we believe that investors should explore a variety of alternatives to prepare for an eventual rise in U.S. bond yields. **Figure 2: Downward Trend in Bond Coupon Rates Barclays U.S. Aggregate Index Coupon Rate: 12/31/98-2/28/15**



Source: Barclays, as of 2/28/15
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For definitions of terms in the chart, visit our glossary. While the timing of an increase in rates remains unknown, we believe that rates may be poised to rise sooner than the market currently expects. At the very minimum, investors should review the level of interest rate sensitivity in their portfolios and assess whether it is consistent with their view of the likely path of interest rates. Strategies that combine traditional bond exposures with interest rate hedges (zero duration) or strategies that “over-hedge” interest rate risk below zero (negative duration strategies) can be bundled efficiently via exchange-traded funds. 1Proxied by the Barclays U.S. Aggregate Index, as of 2/28/15. 2Sources: WisdomTree, Bloomberg, as of 2/28/15. 3Source: WisdomTree, as of 2/28/15. 4Source: Bloomberg, as of 2/28/15.

Important Risks Related to this Article

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