Caron's Corner Transcript – 4.22.2024

Duration: Friend or Foe?

- When times get tough, you often call a friend for help.
- In market terms, when an equity sell-off occurs, you often buy bonds, aka duration, as a hedge.
- **At least that's the way it used to be**. This comes from the 1981-2021 playbook, when bonds were in a 40-year bull market.
- But, **what if the <u>game</u> has changed?** Well then the old playbook is outdated and less useful.
- So what changed the game? Inflation and the related risks that ended the bull market in bonds.
- **We believe we have now entered a new regime**, where bonds are not the easy hedge to equities.
- As such, can duration be a trusted and time-honored reliable hedge to equity volatility? **Is duration is a friend or foe?** We discuss in this audiocast.

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. These days, rising bond yields have been the problem, which prompts us to ask: Is duration a friend or foe? When times get tough, you call a friend for help. Putting this in market terms, when events catalyze an equity sell-off, you buy bonds, in other words duration, for a hedge. That's the way it used to work. Buy bonds long, the longer the maturity, the more duration, the better. This is a page torn from an old playbook from 1981 to 2021 when bonds were in a 40-year bull market.

But what if that game is changed and the old play playbook invalidated? What changed the game? Why of course, inflation risks, and if this is the case, then we have entered a new regime where bonds are not the natural and easy hedge to equities. In fact, we think this is the case today and it leaves us asking the question as to whether duration can be a trusted and time honored, reliable hedge to equity volatility. In other words, is duration is a friend or foe? Let's get into it.

As we think about this, there might be nowhere to run and so we want to look at the causality and the conditionality in the marketplace. What is causing rates to rise and under what conditions? So let's answer the question: Is duration a friend or foe?. Well the answer is "yes." It can be either a friend or a foe and this is what's different today. For the 40-year period from 1981 to 2021 it was only your friend. Today? Duration can both help you and hurt you. But how do we determine which? Well, it's really by examining the causality and the conditionality. Let me explain.

In causality today, inflation risks and less policy easing are pushing yields higher, causing equities to sell off. Owning duration as a hedge to equities is not helping. When we look at conditionality, if the market undergoes a systemic shock or a hard landing or something conditionally aligned in severity, then yes, of course, bond yields will fall and serve as a hedge. But it's conditional on those events being big enough to matter and that's really the key issue. Mathematically what we are saying is that the correlation of

returns between bonds and stocks has risen and entered into a new, higher-correlation regime, where high correlation reduces the hedging benefits that bonds have in relation to stocks. What's driving this high correlation? We go right back to where we started. High inflation risks in the absence of monetary policy to suppress interest rates lower or a regime of low inflation. Then the natural relationship between bond and stock returns finds higher ground at elevated and higher correlation levels. This leaves us back to where we started. High correlations means that bonds or duration is not as reliable of a hedge to equities as it had been in the past. So again, asking the question, is duration or friend or foe, and how do we hedge?

The way that we think about this in the current environment is that you still need to own bonds, but you have to manage your duration, not just passively own it. The start to the answer depends on the prevailing market conditions, where we go back to causality and conditionality. Today’s policy rates are high because inflation is a risk. The yield curve is inverted which sets the initial conditions for longer term bond yields already at low levels, which means that duration is already expensively priced. But the reason policy rates may stay higher for longer and inflation is a risk is because the economy and demand is stronger. Both economic positives actually diminish the value proposition for duration as an optimal hedge for benchmark-driven investors. This may mean still owning duration, but below index or benchmark levels. This may be a better hedge because it reflects the diminished capacity of the duration hedge itself. In practical terms, the index or the benchmark duration for the U.S. Aggregate Bond Index is approximately 6.5 years. So instead of owning the full 6.5 years of duration, perhaps owning something like five or 5.5 years duration could be more optimal.

This hedge has less negative carry and provides an opportunity for relative underperformance if rates move higher. Of course if you believe in a more severe downturn occurring soon, then owning duration would obviously be a better hedge. But you have to have a view that there's going to be a severe downturn and it's going to happen quickly. The point here is twofold 1) finding the optimal duration hedge is not an exact science and 2) you can no longer rely on a 40-year bull trend in bonds to bail you out of ill-placed long duration positions.

Perhaps we'll realize that we never had it so good as we did in that 1981 - 2021 period during the bond bull market. If bonds prove to be a less effective hedge to equities, then the volatility of returns may rise and the opportunity to generate steady compounded returns may fall. However, we recognize the conditions are different today and we're incorporating this analysis into our active management of multi-asset portfolios. This will be an ongoing discussion and we’ll have more on this in later auidocasts.

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CRC 6544061 Exp. 4/30/2025