ecf Insights

ECF Endowment Management | Second Quarter 2023

Do Bonds Still Have a Place in Portfolios?

Bonds are a loan from an investor to a borrower (often a government or corporation). The borrower uses the funds for operations and in return the investor receives interest for a set period of time.

In the past, bonds have been considered defensive investments because they offered investors more stability than equities. And bonds in portfolios typically provide a steady income stream to offset any equity declines during periods of market turmoil. During the 10 worst years for the US Equity markets (excluding 2022), equities declined by an average of 23.8% while long-term bonds increased by 4.3%. (See Chart 1.)

However, in 2022, when equities declined by nearly 20%, average bond prices dropped by 13% (according to Barclays US Aggregate Bond Index), leading many investors to question the role of bonds in a portfolio.

Chart 1: US Equity and US Bond performances during the 10 worst US Equity years

Year	US Equity (S&P 500)	Bonds (Ibbotson LT)
1931	-43.8%	-3.86%
2008	-36.6%	14.44%
1937	-35.3%	-0.21%
1974	-25.9%	1.75%
1930	-25.1%	4.46%
2002	-22.0%	10.10%
1973	-14.3%	-2.57%
1941	-12.8%	3.44%
2001	-11.9%	8.19%
1940	-10.7%	6.91%
Average	**-23.8%**	**4.3%**

Source: Morningstar, Ibbotson, ECF

How Bonds Work

To understand what happened in 2022, let's review how bonds work, starting with bond pricing. The value of a bond is determined by the present value of its future income stream. While equity prices are often dependent on company earnings and growth prospects, bond prices hinge on several factors:

Interest rates play a crucial role, as they determine the annual interest rate paid on a bond. Once a bond is issued, any day-to-day movement in interest rates can cause fluctuations in bond prices.

Credit quality is essential for bond investors. Investors want assurance that the government or company issuing the bond will be able to repay the loan. The bond's credit rating indicates the issuer's dependability. Lower-rated

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Endowment Tip

Is your church making plans for an endowment campaign? Donors give when they see a church use gifts in a way that makes a difference. A successful campaign engages donors with a clear explanation of the current impact of the church and links that impact to its future vision.

To do this, start by identifying the assets of your church. Typically, three of the most important are property, people, and money. Then delve into the impact of these assets by answering these questions:

1. **How is your property supporting the broader community?** Do you make your space available for recovery ministries, a shelter, food pantry, tutoring programs, or the dozens of other ministries we know Episcopal churches house? What difference does that make for the community?

2. **How do the staff care for, educate, and lead the parish? How do members of the parish care for one another?** How do they invite in the broader community? Some of the best stories come when you focus on how the church fosters relationships.

3. **How does the distribution from the endowment sustain the church?** What do those funds make possible?

These stories can help you generate excitement and interest in making a gift. Read more and find one example of an impact story on our blog:

https://www.ecf.org/programs/endowment-management/blog/2/posts/4036/telling-your-endowment-story

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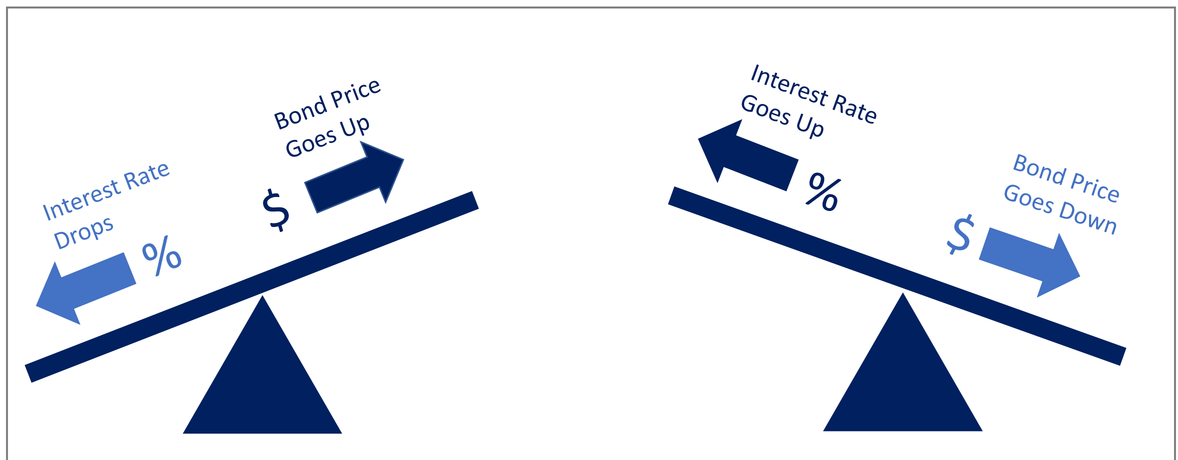
issuers tend to offer higher interest rates which can influence bond pricing.

The maturity date of a bond is important. The maturity date is the date when the principal, or face value, of the bond is paid to investors. Bonds are typically classified into short-term, medium-term, and long-term categories. Bonds with longer maturity dates generally offer higher interest rates.

What Happens to Bonds When Interest Rates Move

Bond prices are very sensitive to interest rate movements, which can impact how they compare to similar bonds in the market. Most bonds have an inverse relationship with interest rates, meaning that when interest rates go up, bond prices typically go down, and vice versa. That's because when interest rates rise, new bonds are issued with higher interest rates, making existing bonds with lower interest rates less attractive to investors and causing their prices to fall. (see Chart 2)

Chart 2: Relationship between Bonds and Interest Rates



Source: ECF

The sensitivity of a bond's price to interest rate changes is known as its "duration." Duration is measured in years and represents the approximate change in the price of a bond for a 1% change in interest rates. As a general rule, a bond with a duration of 2 years would lose about 2% of its value if interest rates rose by 1%. In general, shorter-duration bonds are less sensitive to interest rate changes and longer duration bonds are more sensitive to interest rate movements.

Knowing the Risks

While interest rate risk is a primary risk associated with bonds, there are other risks to consider as well. Here are the most common risks associated with bonds:

- **Interest Rate Risk:** This is the risk that a bond's price will fall with rising interest rates.
- **Credit/Default**: This is the risk that a bond issuer will default on its obligations, resulting in a loss for the investor.
- **Inflation Risk:** This is the risk that inflation will erode the purchasing power of a bond's income. When inflation rises, the value of money decreases. This means the same amount of money will buy fewer goods and services. As a result, the income from a bond may not be enough to cover the cost of living.

Benefits of Bonds in Portfolios

Even with these risks, bonds can bring a number of benefits to a portfolio:

- **Income**: Bonds typically pay a regular stream of interest income, which can provide a steady source of income for investors.
- **Less volatility**: Bonds are typically less volatile than stocks, which means that their prices tend to fluctuate less. This can make bonds a choice for investors who are looking for a more stable investment.
- **Diversification**: Because bonds don't necessarily move in tandem with stocks, they typically help to provide diversification in an investor's portfolio. This can help to reduce risk and improve overall returns. The next section explains why this did not work in 2022.

What Happened to Bonds in 2022?

2022 was a tough year, not just for equities but also for bonds. US Equities were down nearly 20% and bonds were down around 13%. Bonds, often known for less volatility, had their worst year since 1976.

How did 2022 land in the record books? Starting in late 2021, inflation (as measured by the Consumer Price Index or CPI) rose steadily until June 2022, peaking at 9.1%. In response, the Federal Reserve aggressively raised interest rates to slow

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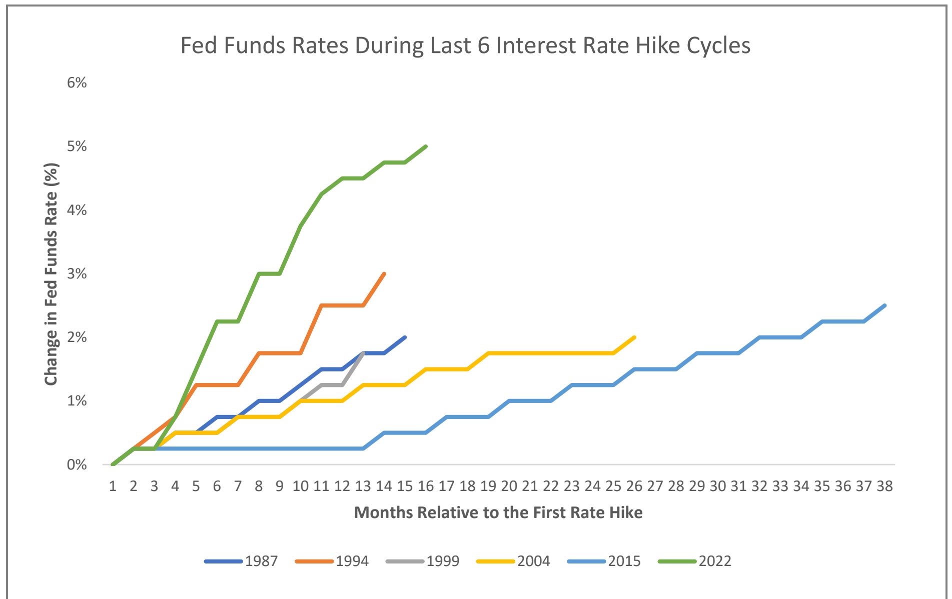
the US economy and combat inflation. Between March 2022 and May 2023, the Fed Funds rate was raised by 5.00%, a more rapid pace than in any of the previous five rate hike cycles (see Chart 3). Not surprisingly, bond prices dropped as rapidly as interest rates rose. Although increases affected just the short-term rates (Fed Funds rate), rising interest rates filtered through to the rest of the bond market. In other words, bonds experienced interest rate risk. Historically, bonds have performed better during previous rate hike cycles when hikes occurred at a slower pace, stretching over longer periods in smaller increments.

Chart 3: The pace of Fed rate hikes in cycle has been rapid



Source: Source: St Louis Federal Reserve FRED

Diversification broke down. Many portfolios are diversified across equities and bonds to minimize performance variability, but the simultaneous decline in both asset classes reduced the typical benefit of diversification. In many previous downturns, bonds held steady even as equities declined (see Chart 1). Why was it different in 2022? Both bonds and equities are sensitive to higher interest rates and higher inflation. When interest rates rise, the value of bonds falls. As for equities, higher inflation leads to higher input costs, lower profits and ultimately lower equity prices. 2022 was an unusual year and as inflation ebbs, bonds and equities are expected to resume a normal course.

Sigh of Relief for 2023

As the dust settles from a tumultuous 2022, glimmers of hope are emerging for fixed income investors.

- **Inflation:** As inflation begins to decline, the possibility of lower correlations between equities and bonds could restore diversification benefits to portfolios.
- **Interest Rates:** The possibility of a pause in interest rate hikes or even a potential reversal later this year could provide investors with a much-needed breather.
- **Higher Bond Yields:** Bond yields have climbed to their highest levels in years, providing investors with an income stream that they haven't experienced in over a decade.

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Upcoming Webinar

Truth About Endowment Spending

Does your approach to endowment spending need to change with the times? . Are you correctly interpreting restrictions on spending? How can you agree on how much to spend annually? What about spending on operating expenses? Or not spending at all?

Join ECF's endowment experts for a 30-minute webinar:

Tuesday, June 13 at 2 pm Eastern

REGISTER: https://bit.ly/endowmentspending