Bonds versus equities

A dynamic understanding of market correlation

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One of the most pervasive investment beliefs is that bonds offer protection when equity markets fall. The reality is far more nuanced as many investors painfully found when interest rates began their rapid rise in May 2022.

The ride was volatile but international fixed interest lost 12.3 percent last year while Australian fixed interest lost 9.7 percent. Meanwhile, global equities lost 12.5 percent and Australian equities lost 1.1 percent.[1]

The performance of bonds and equities was highly correlated—they both went down at the same time. In fact, a look back at the last 100-plus years shows that bond and equity returns spent more time correlated than non-correlated on a rolling three-year basis, as shown in Figure 1.

From the 1960s to 2000, the correlation was largely positive in both falling markets such as the 1970s, and rising markets such as the period from 1982 to 2000. From there, bonds and equities became strongly negatively correlated during periods of stress.

It takes a deeper dive into the data to find out why.

The importance of price and underlying risk factors

The reason asset class correlations change is because they are not always driven by the same underlying risk factors.

When it comes to bonds, prices are closely related to interest rates, so price is one of those risk factors and helps to explain the different ways bonds performed during the tech wreck, the Global Financial Crisis (GFC), and the more recent central bank interest rate hiking phase.

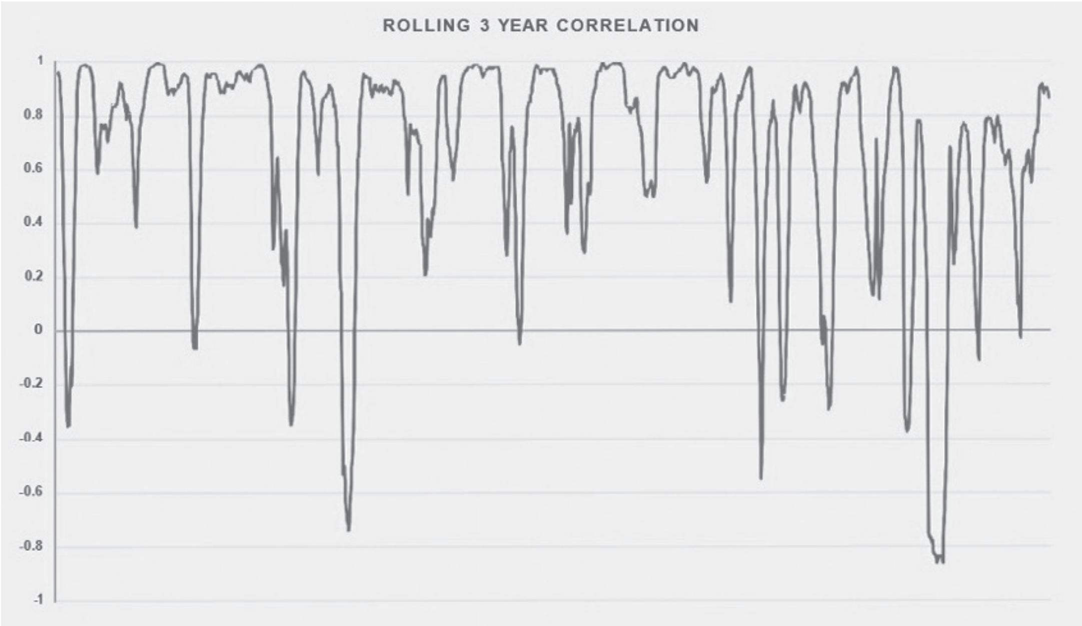
The US tech wreck from 2000-2002 was largely driven by an isolated factor—the collapse of an over-valued technology sector—rather than broader macro-economic factors such as a fall in corporate earnings or a spike in inflation.

The Australian sharemarket, with a much smaller exposure to tech stocks, performed relatively well compared to the US sharemarket. Australian bonds also performed well because they were offering double-digit yields, hence the starting price was low, as bond prices and yields are inversely related. Accordingly, investors turned to the asset class as a relative safe haven.

The situation was quite different leading into the 2007 GFC, which was driven by a common underlying risk factor across most major asset classes. Credit yields were trading at very low levels in the bond market, particularly the high-yield sector, hence the starting price was high—alongside this was the inherent systemic risk of entering a stressed credit environment.

The credit environment, which feeds through into all investible asset classes, changed from benign to stressed. Combined with the over-valuation across many asset classes, the 2008 crash ensued. It dragged down most major asset classes including corporate bonds

Figure 1. Rolling 3-year correlation of Australian bond and equity returns over 160 years



Source: Global Financial Data, Innova Asset Management

and equities. In the aftermath, government bonds once again outperformed as prices were extremely low and yields were strong.

The situation was different again in 2022 after years of ultra-low interest rates. Government bond prices were high and yields were very low, so when inflation surged and interest rate hikes followed, bond prices naturally fell. At the same time, rising rates also dampened the sharemarket's prospects—both shares and bonds fell together. This underlines the fact that the starting price of an asset plays a significant role in the level of long-term returns it will generate.

Make decisions based on evidence, not beliefs

Markets are complex so it is understandable that people use quick rules of thumb or *heuristics* to make decisions—the problem is they are often wrong.

There are times when bonds can prove to be a good portfolio diversifier and offer a level of protection against equity market falls, but it depends on the underlying risk factors at play rather than arbitrary rules or beliefs.

Many investors underestimated the risk that interest rates would rise last year while others thought the US Federal Reserve would come to the rescue again by cutting rates or keeping them low.

Instead, the fast pace of rate hikes hurt many 'balanced' investor portfolios and played a key role in the collapse of two US banks. Silicon Valley Bank (SVB) and Signature Bank both invested far too much of their at-call depositor funds into long-term US government bonds and mortgage-backed securities. When nervous depositors lined up to withdraw their money (a 'bank run'), the value of those assets was no longer enough to enable the banks to meet their obligations.

The current high interest rate environment is likely to expose more similar asset-liability mismatches because investors failed to analyse the data or manage the risk appropriately.

Risk and return are always deeply intertwined. Investors must keep making changes to reflect the environment. Innova had a large underweight to bond duration last year given the risk of rising rates was substantial—which would hurt bond prices. Bond duration is a measure of interest rate risk. The higher the duration of a bond—that is, the longer you need to wait for the payment of principal while receiving a fixed coupon payment—the more its price will drop as interest rates rise.

The situation is different today.

Bond prices have come down to more attractive levels—as yields have risen—and so we have increased our allocation. Price and other underlying risk factors play a key role in whether bonds will offer protection when equities fall, but only an ongoing analysis of the data and the changing environment can reveal when the time is right. **FS**

Notes

1. Aust. Fixed Interest: Bloomberg AusBond Composite 0+ Yr TR AUD; International Fixed Interest (H): BarCap Global Aggregate TR Hdg AUD; Australian Equities: S&P/ASX 200 TR; International Equities: MSCI World Ex Australia NR AUD

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The quote

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Dan Miles is the managing director & co-chief investment officer of Innova Asset Management. Innova is a boutique risk-focused portfolio manager that has been managing client portfolios since 2010. Innova was founded on the principles of providing robust and research-intensive insights to help investors meet their financial goals. The firm focuses on managing the multi-faceted nature of investment risks for clients.