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Expert Perspective

Why intermediate-term bonds are still relevant for your clients

Introduction

You may find it challenging to help clients understand the value of intermediate-term bonds, especially after the painful losses of last year. In addition, your clients may question why they should invest in intermediate-term bonds when cash equivalents, for now, earn more.

In this environment, many advisors have built bond portfolios with shorter duration profiles. In fact, roughly three out of four advisor portfolios that our Portfolio Solutions team reviewed in the first half of 2023 maintain meaningful underweights to duration.

This strategy may be a good choice for some client's portfolios, but not all. When deciding between short- and intermediate-term bonds, it's crucial to help your clients understand the pitfalls of persistently underweighting duration, and the importance of matching the duration target to their goals and timeframe.

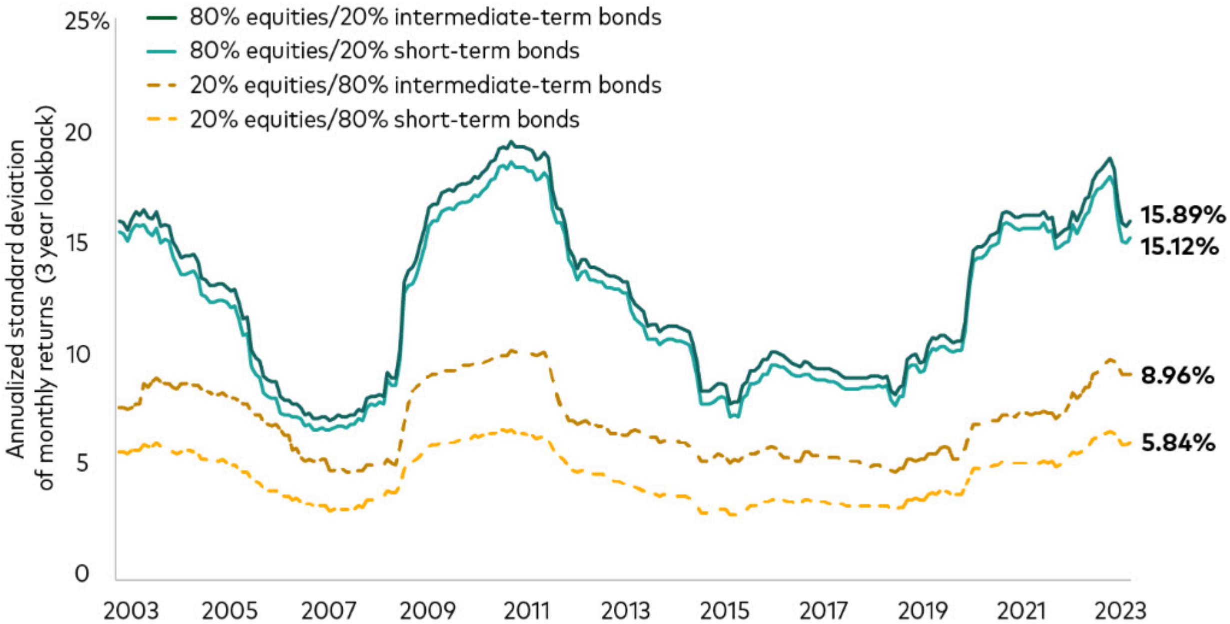
Portfolio volatility matters more to your clients than position volatility

Since duration measures a bond fund's price sensitivity to changes in interest rates, a fund with shorter duration will experience less price volatility than one with longer duration. As advisors, you're focused on your clients' entire portfolio, not just fixed income, so it's likely you pair bonds with equities, alternatives, and cash, each carrying their own unique risk attributes.

In multi-asset class portfolios, reducing the duration of your bond sleeve won't always meaningfully reduce volatility for your clients. As you increase allocation to other asset classes, the impact of your bond sleeve's duration on the risk of the overall portfolio begins to fall.

Figure 1 demonstrates that replacing intermediate-term bonds with short-term bonds can have vastly different relative impacts on portfolio volatility, depending on your clients' equity allocations. In the portfolio with 80% equities and 20% fixed income, the level of volatility, as measured by standard deviation, is less influenced by shifts in duration (choosing short- versus intermediate-term bonds). The portfolio that is 20% equities and 80% fixed income, in contrast, is much more influenced by shifts in duration.

Figure 1: More duration does not always mean more risk



Notes: Vanguard data from 12/31/2001—6/30/2023. The short-term bond portion of these portfolios is represented by the Spliced Bloomberg US 1-5 Year Government/Credit Float Adjusted Index, which includes the Bloomberg US. 1—5 Year Government/Credit Bond Index through December 31, 2009; Bloomberg US 1–5 Year Government/Credit Float Adjusted Index thereafter. The intermediate-term bond portion is represented by the Spliced Bloomberg US 5-10 Year Government/Credit Float Adjusted Index, which includes Bloomberg US 5–10 Year Government/Credit Bond Index through December 31, 2009; Bloomberg US 5—10 Year Government/Credit Float Adjusted Index thereafter. The equity portion is represented by the spliced Total Stock Market Index, which includes the Dow Jones US Total Stock Market Index (formerly known as the Dow Jones Wilshire 5000 Index) through April 22, 2005; MSCI US Broad Market Index through June 2, 2013; and CRSP US Total Market Index thereafter.

Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

As the equity allocation in your portfolio increases, it is responsible for a greater portion of volatility in the portfolio. As this occurs, fixed income's contribution to portfolio risk exponentially declines.

This is because equities are more volatile than bonds. If your goal is to lower volatility in equity-heavy portfolios, making changes to duration within your fixed income sleeve is not efficient (see 80/20 allocation in Figure 1). Focusing too much on duration risk may eat up enormous brainpower and time without proportional impact on clients' outcomes.

It's important to note that lower duration tilts may make sense for clients in fixed-income-heavy portfolios where duration risk can have a greater impact on volatility (see 20/80 allocation in Figure 1). In these cases, especially for clients who are distributing income for current spending needs, matching duration profiles to shorter time horizons can help ensure portfolio volatility remains in line with their specific needs.

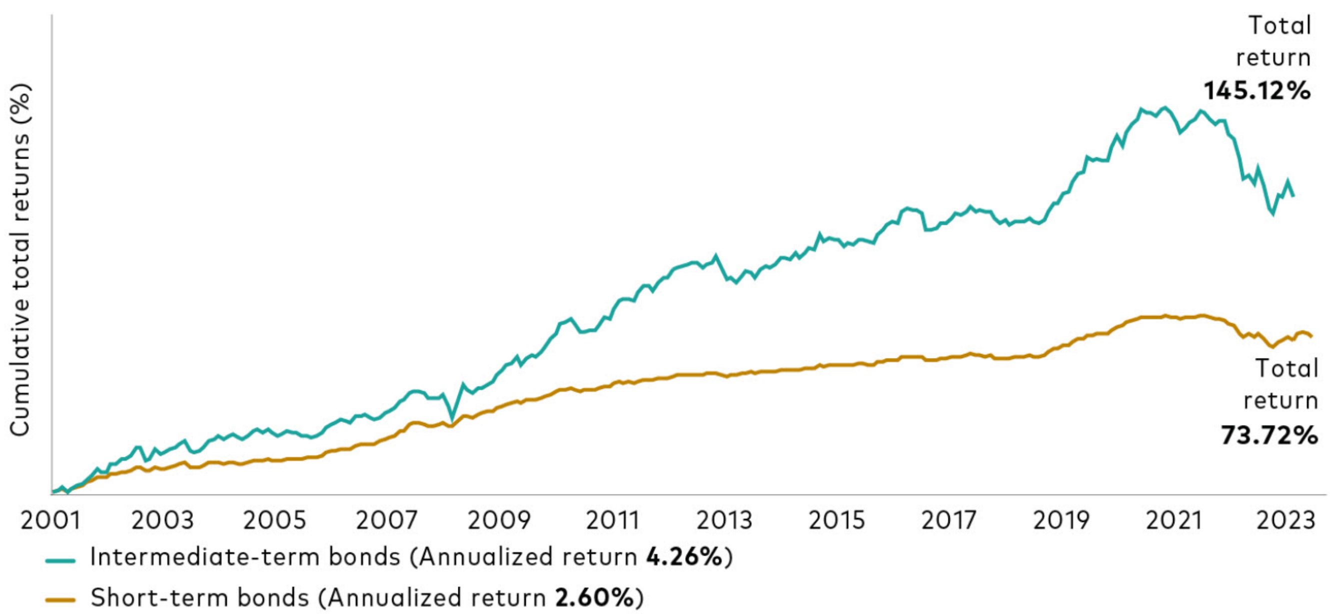
Intermediate-term bonds can boost client total returns over time

Reducing duration for your long-term clients is more likely to reduce total returns than volatility, especially now that yields are at more attractive levels.

Figure 2 demonstrates the benefit of compounding interest on reinvested bond coupon payments (income return) over an extended period. Long-term investors should remain focused on both components of bond total returns: price return and income return. Even when we include the unusually large drawdowns of 2008 (—9.18%) and 2022 (—16.62%), your long-term clients were still better off using intermediate-term bonds because the higher and more durable yields compound faster over time.

The bottom line: Don't let excessive fear about duration risk disrupt your clients' long-term total returns.

Figure 2: Intermediate term bonds pay off over the longer run



Source: Vanguard, 11/30/2001 – 6/30/2023. The short-term bond portion of these portfolios is represented by the Spliced Bloomberg US 1—5 Year Government/ Credit Float Adjusted Index, which includes the Bloomberg US 1–5 Year Government/Credit Bond Index through December 31, 2009; Bloomberg US 1–5 Year Government/Credit Float Adjusted Index thereafter. The intermediate-term bond portion is represented by the Spliced Bloomberg US 5—10 Year Government/ Credit Float Adjusted Index, which includes Bloomberg US 5—10 Year Government/Credit Bond Index through December 31, 2009; Bloomberg US 5–10 Year Government/ Credit Float Adjusted Index thereafter.

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More durable yields improve your ability to forecast client outcomes

Duration risk is only one risk. Yield risk, or reinvestment risk, may pose a far greater threat to clients' returns. Higher current yields on short-term bonds may seem like a great solution on the surface, but the level of rates and the shape of the yield curve do not move in predictable ways.

One of your many responsibilities as an advisor is to map out a range of potential outcomes for your clients and stack the probabilities of success in their favor. Current bond yields, and, most importantly, the volatility of changes in those yields, are major inputs that help formulate the capital market assumptions that fuel your financial planning tools' forecasts.

A practical financial planning benefit of favoring intermediate-term bonds is that their yields tend to be more durable (and less volatile) compared to their short-term peers.

The relative stability of intermediate-term bond yields, especially over decades of investing (the typical planning cycle), can improve the chances that your clients' outcomes will align more closely with your initial planning forecasts—the ultimate Advisor's Alpha®. Choosing to focus on this long-term benefit is not always easy, but it's worth it, and we think you should lean into it.

By helping your clients understand that more duration does not always mean more risk and showing them the benefits intermediate-term bonds can offer over the longer run, you can help them see the value you provide.

All investors should have an allocation to cash and/or short-term investment solutions for day-to-day and emergency fund needs, but they are not appropriate for all situations. By matching your duration strategy to client needs and timeframes, you can:

- Avoid the guesswork of timing the markets.
- Be confident that you are focusing efforts to reduce portfolio volatility on the right assets.
- Take advantage of the opportunity to lock in higher yields over the long run.
- Forecast client outcomes more accurately.

How we can help

Our passive products can help you build portfolios to better match benchmarks, pair with active strategies to smooth out active risk, or even help you express required strategic or tactical tilts for unique client situations.

Check out our ETF lineup

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Bond funds are subject to the risk that an issuer will fail to make payments on time, and that bond prices will decline because of rising interest rates or negative perceptions of an issuer's ability to make payments.

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